How Do LLC Owners Contract Around Default Statutory Protections?

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Limited liability companies are built on the idea of contractual freedom. Unlike with other business organization forms, most owner protections apply only by default to LLCs, which are free to waive or modify them as desired. This freedom promises economic efficiency if parties are sophisticated but raises the potential for opportunism by relatively more sophisticated managers and majority owners. While companies ranging from small landscape firms to Chrysler and Fidelity organize as LLCs, remarkably little is known about whether or how LLCs use this contractual flexibility.

I analyze the operating agreements of 283 privately owned LLCs organized under Delaware and New York law to determine when and how parties alter default provisions. I find widespread use of LLC statutes' flexibility to decrease default owner protections, as well as widespread adoption of owner protections that do not apply by default. There is little evidence, however, that the contractual freedom is used to craft systematically more efficient contractual owner protections. Instead, using a proxy for owner vulnerability, I find that LLCs with more vulnerable owners adopt significantly fewer owner safeguards, suggesting that contractual freedom may be used more often for opportunism and not for efficiency.

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I. INTRODUCTION

Since the first enabling statute was passed in 1977, limited liability companies, or LLCs, have exploded in popularity. There are now over 2.2 million LLCs, dwarfing the number of traditional corporations by almost 40% while continuing to grow at a rapid pace.[1] Companies ranging from the neighborhood lawn care service provider to Chrysler

1. Ron DeCarlo & Nina Shumofsky, *Partnership Returns, 2012*, IRS, fig. G (2015), http://www.irs.gov/pub/irs-soi/soi-a-pa-id1504.pdf (2.2 million LLCs); Statistics of Income, *Corporation Income Tax Returns, IRS*, fig. I (2011), http://www.irs.gov/pub/irs-soi/11coccr.pdf (1.6 million active corporations); Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of*

and Fidelity organize as LLCs.[2] Publicly traded companies as well as the exchanges they trade on are LLCs.[3] Several of the largest privately held companies in the world similarly choose the LLC business form.[4]

A common reason to adopt the LLC structure is to achieve limited liability protection with only single taxation of profits. This advantage, however, has long been attainable through competing partnership and corporation forms.[5] But LLCs combine this limited liability with almost complete contractual flexibility. Practically every corporate law mandatory rule aimed at protecting owners, such as manager fiduciary duties, is only a default for LLCs. The protections apply by default, but LLCs are free to waive or modify them as desired. The contractual freedom "contractarian" approach is built on the expectation that sophisticated LLC owners are capable of crafting optimal governance provisions that may or may not include traditional protections. Because traditional corporate protections impose costs on the firm and its owners, waiving them can be desirable when parties adequately protect themselves through other, more efficient means. Eliminating fiduciary duties, for example, may reduce what managers charge to run the firm, and the elimination could be entirely appropriate if manager opportunism is constrained through other means.

Not everyone thinks that traditional protections should be merely defaults for LLCs, however. Eliminating owners' standard protections can be problematic if those owners are not sophisticated and underestimate the protections' value. Because mandatory corporate law rules exist to align manager and owner interests, waiving that protection opens the door to value-reducing opportunism. For example, unsophisticated owners who waive managers' fiduciary duties without adopting substitute protections may later be surprised to have no recourse when managers engage in self-dealing. The results are undesirable from both efficiency and equity grounds. For this reason, traditional owner protections are mandatory for corporations and cannot be waived even if the parties wish to do so. The need to protect vulnerable owners of corporations is deemed superior to the efficiency gains that might result through sophisticated bargaining.

The desirability of treating mandatory corporate protections as only default provisions for LLCs therefore boils down to an issue of how LLCs' contractual freedom is used. Are sophisticated owners using LLC statutes' flexibility to construct more efficient arrangements than are permissible under corporate law? Are unsophisticated owners induced to waive protections, giving rise to the potential for opportunism that motivates mandatory protections for corporations? Or are LLCs neglecting to take

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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, 460 (2010) (estimating new LLCs outpacing new corporations by a two-to-one margin).

2. *About Us*, FCA, http://www.fcanorthamerica.com/company/AboutUs/Pages/AboutUs.aspx (last visited Mar. 8, 2017); *Our Heritage*, FIDELITY, https://www.fidelity.com/about-fidelity/our-heritage (last visited Mar. 8, 2017).

3. *E.g.*, TRAVELCENTERS OF AM. LLC, 2014 ANNUAL REPORT 8, http://www.ta-petro.com/assets/ce/Documents/2014Annual%20Report.pdf (2014); In the Matter of NYSE LLC et al., Exchange Act Release No. 72,065, 2014 WL 1712113, at *1 (May 1, 2014) (identifying the New York Stock Exchange and the former American Stock Exchange as LLCs).

4. For example, 2 of the 14 largest, privately held American companies are LLCs (Albertsons and Pilot Flying J), accounting for almost $82 billion in annual revenue in 2016. *America's Largest Private Companies*, FORBES, http://www.forbes.com/largest-private-companies (last visited Mar. 8, 2017).

5. S corporations in particular often compete with the LLC form for these advantages.

advantage of contractual freedom and instead choosing the LLC form solely for tax reasons? Despite the importance of these questions in light of LLCs' emerging dominance, little systematic effort has been spent in understanding whether and to what extent LLCs use their contractual freedom to allocate owner rights and responsibilities.[6] For example, Professor Larry Ribstein, in several influential pieces, argued forcefully in favor of LLC contractual freedom because of its superior potential for crafting efficient owner protections.[7] LLCs must actually avail themselves of the flexibility for this situation to be the case, yet Ribstein never conducted a systematic analysis of LLCs' operations to determine if or how his theory played out in practice. On the opposite side of the debate, Leo Strine and J. Travis Laster, Delaware Supreme Court Chief Justice and Delaware Court of Chancery Vice Chancellor, respectively, recommend sacrificing contractual flexibility in favor of mandatory LLC owner protections because of a perceived need to help vulnerable owners. Such a recommendation again requires knowing how LLCs actually use contractual flexibility to draft their governance provisions.[8] Others have similarly argued for and against reining in LLCs' contractual freedom based on behavior reported in a handful of prominent cases.[9]

I address this disconnect through an in-depth analysis of privately owned LLCs' operating agreements—the LLC analog of corporate charters and bylaws that allocate rights, responsibilities, and protections among owners and managers.[10] I analyze a set of 283 operating agreements to determine when and how default terms are modified. I find that parties regularly use LLCs' contractual flexibility to reduce or eliminate traditional owner safeguards in ways not replicable under corporate law. For instance, LLCs often eliminate fiduciary duties; authorize owners and managers to compete directly with their

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6. Notable exceptions have been contributed by Mohsen Manesh, Michelle Harner, Jamie Marincic, and Suren Gomtsian. Their studies' contributions and their limitations are *discussed infra* Part III.

7. LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010); Larry E. Ribstein, *Fencing Fiduciay Duties*, 91 B.U. L. REV. 899 (2011); Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy,* 2009 U. ILL. L. REV. 131; Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407 (1999).

8. The Justice and Judge extrapolate from their sizeable yet anecdotal experience on the bench. 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 (Mark Lowenstein & Robert Hillman eds., 2015).

9. For examples of those in favor of limiting LLCs' contractual flexibility, see Benjamin Means, *Contractual Freedom and Family Business*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 40 (Mark Lowenstein & Robert Hillman eds., 2015) (arguing for a particular need for default and mandatory rules for family businesses); Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract Deity*, 14 FORDHAM J. CORP. & FIN. L. 445, 465–71 (2009); see generally SANDRA K. MILLER, LIMITED LIABILITY COMPANIES: A COMMON CORE MODEL OF FIDUCIARY DUTIES (2015); Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More than a Decade of Experimentation?*, 32 J. CORP. L. 565 (2007); Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609 (2004). For examples of those against limiting LLCs' contractual flexibility, see Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Liability Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221 (2009); Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnership and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007); Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123 (2006).

10. While LLCs file a certificate of formation that formally is analogous to the corporate charter, LLCs' certificates of formation are surprisingly devoid of substance, specifying the company name, the registered office, the registered agent, and typically little else.

companies; waive the corporate opportunity doctrine; and even eliminate owners' right to seek judicial dissolution. These actions significantly cut back the protections enjoyed by owners of traditional corporations and other organizations. For many, therefore, the decision to organize as an LLC involves more than just achieving single tax treatment of profits.

But LLCs also add various protections to their operating agreements that are neither required nor apply by default, filling some of the void from reducing default protections. These include a regular dividend distribution; a specified business purpose; a limited lifetime; a restriction on majority owners' ability to sell their ownership stake; and aligning owner and management interests by compensating LLC management with significant profit shares.

Many LLCs therefore are discarding default judicial and statutory protections that are mandatory for corporations, and employing substitute safeguards. This more finely tailored approach has the potential to maximize entity value and create efficient governance relationships in ways not replicable through traditional corporate law. If parties were contracting around default terms in pursuit of efficiency, one prediction of the contractarian approach is that we would expect an inverse relationship between reductions and additions: as traditional corporate protections are circumscribed, other protections would be written in to fill the void. However, I find no significant relationship between the subtraction of and addition to owner protections, either among LLCs as a whole or among those LLCs identified as likely to have more sophisticated parties. This finding suggests that when LLCs wield their contractual freedom, they do not systematically do so to trade off traditional corporate protection for better substitute contractual terms as envisioned by contractarian proponents.

On the other hand, I find that LLCs identified as likely to have more vulnerable minority owners—those owners who invest little in the LLC and are less likely to seek sophisticated legal counsel—adopt significantly fewer owner safeguards than LLCs with less vulnerable owners. This result suggests that LLCs may instead be using their contractual freedom to set up later opportunism by managers and majority owners.

These findings have several implications. First, they shine a light into the dark space of LLC operations. Despite their significance as a form of doing business, LLCs remain understudied because privately held companies are not subject to disclosure requirements. This Article shows what LLCs are actually doing, which is useful for studying a wide variety of questions in this increasingly important field.

The results also provide concrete evidence for the evolving debate on whether LLCs require mandatory owner protections. Much of the discussion has suffered from a lack of knowledge about how LLCs use their contractual flexibility. Because I find little evidence for sophisticated bargaining and instead evidence of opportunism, the results suggest both a greater need for minority owner protections and that the cost to sophisticated LLCs of implementing protections may be small. However, because LLCs currently modify protections in such diverse ways, implementing new protections must be done carefully, and imposing mandatory rules could bring significant costs.

Part II provides the basics of the LLC organizational form. I describe LLC fundamentals, including relevant judicial and statutory safeguards, and compare these to the law of competing types of business organizations. I also introduce the debate surrounding the need for mandatory LLC owner safeguards and show how it revolves around largely untested assumptions about how LLCs behave in the real world.

Part III summarizes the existing empirical literature on LLC operating agreements and shows the continued need to understand what motivates LLCs' decision to modify default protection provisions. Parts IV and V provide the results of my study of private LLC operating agreements. I show the diverse ways that parties both augment and detract from default owner protections. The study is based primarily on a sample of 233 Delaware LLCs, but to assess the representativeness of these results, I compare them to a sample of 50 LLCs organized under New York law. The New York sample shows roughly similar use of LLCs' contractual flexibility to waive and modify traditional corporate protections.

Part VI synthesizes the preceding results by testing the motivations behind modifying the default protections that apply to LLCs. I find little relationship between the prevalence of strengthening and weakening owner protections, either for the sample as a whole or for the subset of LLCs with exclusively less vulnerable owners. However, I find significantly lower levels of owner protection for those LLCs with less sophisticated and more vulnerable minority owners. While this test of one component of the contractarian approach does not necessarily imply a complete lack of efficiency bargaining, the results suggest a need for devising new measures to protect minority owners, and I offer some thoughts on the relative tradeoffs of doing so through statutory and other means.

II. THE LAW OF LLCS

LLC statutes were developed with the twin goals of providing comprehensive limited liability protection to owners while avoiding the double taxation on earnings incurred by corporations. Until LLCs, entrepreneurs were faced with choosing either weakened liability protection through a partnership entity, gaining strong liability protection at the cost of double taxation via C corporations, or mixing the advantages of both but restricting the available types of owners and equity via an S corporation.[11] LLCs combined the best of all possible worlds, importing the limited liability protection of a corporation and achieving partnership-like single tax treatment.[12]

Most states graft onto this original motivation a commitment to freedom of contract.[13] This contractual freedom stands in contrast to the mandatory rules of corporations and partnership entities. Corporations, the typical alternative to an LLC, are governed by a set of required statutory and judicial rules that restrict manager and owner behavior.[14] These rules primarily address costs that arise when a firm's decision maker

11. *See* Kleinberger, *supra* note 9, at 451–56 (discussing the history of LLCs). S corporations, while coupling the limited liability of a corporation with the single taxation of a partnership, restrict ownership to at most 100 shareholders comprised solely of domestic individuals, exempt nonprofits, or trusts (thereby ruling out foreign investors and domestic partnership or corporation investors). S corporations are also allowed to issue only a single class of stock. IRS, *Instructions for Form 2553* (2013), http://www.irs.gov/pub/irs-pdf/i2553.pdf.

12. IRS, *IRS Form 8832* (2013), http://www.irs.gov/pub/irs-pdf/f8832.pdf. Such entities will later be subject to corporation-like double taxation if they are deemed by the IRS to be "publicly traded." 26 U.S.C. § 7704 (2008).

13. *See, e.g.*, LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES App. 9:6 (2016) (summarizing state LLC law fiduciary waiver provisions).

14. The discussion at this stage shifts to comparing LLCs' contractual flexibility to that of (S and C) corporations, which provide limited liability comparable to that of LLCs. Partnerships, even those with "limited" in their name, typically only roughly approximate the all-important limited liability protection offered by LLCs and corporations or are available only for professional services firms. *See* NICHOLAS MURRAY

does not bear the full consequences of her actions, leading her to profit at the firm's expense. For instance, when a firm's manager receives less than all of the firm's profits—as is necessarily the case for firms with more than one owner—she has the financial incentive to expropriate firm value through reduced effort, obtaining perquisites, tunneling profits into related entities, and the like because she gains the entire upside of the self-interested behavior while suffering only a portion of the firm's decreased profitability. Similarly, a controlling owner may opportunistically sell her control stake to a less desirable owner or pressure management to benefit herself at the firm's expense. The mandatory rules familiar in corporation and partnership law seek to minimize this opportunism by aligning managers' and owners' interests with the firm's.

One way this alignment is achieved in corporate law is through restricting the available decisions that can be made, trying to ensure that discretion is exercised in the best interests of the firm rather than in the decision maker's self-interest. Business law accomplishes this goal by imposing fiduciary duties, a topic quite familiar to scholars and students of business associations. Managers of corporations and certain partnerships owe duties of loyalty, good faith, and care to their firms. While these requirements have retreated from the pinnacle enunciated by Justice Cardozo's colorful *Meinhard v. Salmon* language,[15] the concept of protecting owners through fiduciary duties remains strong. Corporate managers must put the firm's interests above their own, must avoid fraud or illegal conduct, and must act without gross negligence in carrying out their responsibilities.[16] These basic fiduciary duties have extended into additional freestanding doctrines to restrict managers from competing with their firms or from seizing business opportunities for themselves.[17] The principles also can extend beyond managers and apply to particular owners, as with the duties that controlling owners owe to minority owners.[18]

The second way that business law aligns manager and owner interests is to proscribe management from unilaterally making certain fundamental decisions without the additional consent of owners. These decisions, including merging or disposing of substantially all of the firm's assets,[19] voluntary dissolution,[20] amending the corporate

BUTLER, WHY SHOULD WE CHANGE OUR FORM OF GOVERNMENT?: STUDIES IN PRACTICAL POLITICS 82 (1912) ("[L]imited liability [of a] corporation is the greatest single discovery of modern times . . . . Even steam and electricity are far less important . . . and they would be reduced to comparative impotence without it."); Kleinberger, *supra* note 9, at 449, 455–56 (describing limited effectiveness of attempts to replicate LLC and corporate limited liability through partnership forms). Much of the comparison between LLCs and corporations can also be made between LLCs and partnerships, the latter of which also limit parties' contractual freedom in various ways. *See, e.g.*, REVISED UNIFORM P'SHIP ACT § 103 (UNIF. LAW COMM'N 1997) (listing mandatory rules for partnerships).

15. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928); *cf.* Ind. Civil Rights Comm'n v. Kightliner & Gray, 567 N.E.2d 125 (Ind. Ct. App. 1991) (enforcing prenegotiated contractual language over a principle of utter selflessness).

16. *See, e.g.*, MODEL BUS. CORP. ACT §§ 8.30(a), (b), 8.42 (COMM. CORP. LAWS 2008).

17. On non-competition, see *id.* § 8.31 cmt. (g); Sci. Accessories Corp. v. Summagraphics Corp., 425 A.2d 957, 965 (Del. 1980) (citing several cases). On the partnership and corporate opportunity doctrines, see generally Broz v. Cellular Info. Sys., 673 A.2d 148 (Del. 1996) (corporate opportunity doctrine); Kahn v. Icahn, No. Civ. A. 15916, 1998 WL 832629 (Del. Ch. Nov. 12, 1998) (partnership opportunity doctrine); Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L.J. 277 (1998) (analyzing the corporate opportunity doctrine).

18. *E.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

19. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 251(c), 271 (2016, 2012).

charter,[21] and electing directors,[22] all require owner approval before they can be implemented by a corporation's management. As with fiduciary duties, these rules require that certain activities vulnerable to value-reducing, self-interested behavior can be made only with owners' explicit consent.

For most organizational forms, these owner protections are mandatory, meaning that they apply even if the owners prefer to eliminate them. Mandatory rules provide paternalistic protection to unsophisticated parties who might underestimate the protections' value or mistakenly waive them.[23] But because these mandatory protections also have costs, requiring them as mandatory is less compelling when owners are sophisticated and able to protect themselves and curb opportunism through monitoring, contracting, or other means.[24] If a particular behavior is proscribed or a right cannot be waived, situations when it would be mutually profitable to engage in that behavior or waive a right are lost. For instance, managers might accept lower management fees if they could engage in limited competing activities independently, and the direct savings from lower management fees could more than compensate owners for the waived protection—a trait often observed in private equity and venture capital.[25] Less obvious, but still important, can be the costs saved by avoiding litigation over alleged violations of traditional corporate protections.[26] Aligning owners' and management's incentives through sophisticated bargaining can therefore be superior to imposing mandatory corporate law protections, ultimately enhancing the value of the firm. But when conducting their business via a corporation or certain partnership forms, owners' freedom to substitute these alternatives for corporate protections is limited or eliminated entirely.

LLC statutes like Delaware's take a more permissive approach. These statutes embrace contractual flexibility, assuming that sophisticated parties can craft the agreements that best achieve their goals without imposing mandatory protections.[27] Traditional mandatory protections apply, if at all, only by default, allowing parties to

20. DEL. CODE ANN. tit. 8, § 242 (2014); MODEL BUS. CORP. ACT § 14.02 (COMM. CORP. LAWS 2010).

21. DEL. CODE ANN. tit. 8, § 275; MODEL BUS. CORP. ACT § 10.03.

22. DEL. CODE ANN. tit. 8, § 211(b); MODEL BUS. CORP. ACT § 8.03.

23. *Cf.* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 25 (1991) (justifying mandatory terms where, because of market failures, those terms are not priced). Less commonly, the mandatory approach is justified as correcting for negative externalities if their waiver undermines business norms that facilitate trust and good governance. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001) (recognizing the feedback among duties, management behavior, and social norms).

24. *See* Ribstein, *Fencing Fiduciary Duties*, *supra* note 7, at 905–08 (identifying the costs arising from mandatory fiduciary duties).

25. *See generally* Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004) (analyzing fiduciary duty waivers in limited partnerships, including venture capital firms); Terence Woolf, Note, *The Venture Capitalist's Corporate Opportunity Problem*, 2001 COLUM. BUS. L. REV. 473 (discussing conflicts between the corporate opportunity doctrine and venture capital investing); Larry E. Ribstein, Univ. of Ill. College of Law, *Wall Street and Fiduciary Duties: Hearing Before the S. Comm. on the Judiciary*, 111th Cong. (arguing that fiduciary duties are inappropriate in the investment banking industry).

26. Litigation expenses encompass not just the expenditures with defending non-meritorious suits, but also the costs associated with having a court's judgment substituted for a business expert's. Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 241 (2009) (noting the necessity of deferring to management and the "potentially harmful" effects of shareholder interference).

27. *E.g.*, Zimmerman v. Crothall, 62 A.3d 676, 691 (Del. Ch. 2013) ("The LLC Act provides contracting parties with flexibility to craft an agreement that is tailored to their needs.").

modify or eliminate them if desired through terms in the LLC's operating agreement. If LLC owners do not want the mandatory protections offered under corporate law, they may affirmatively waive them in the operating agreement or just refrain from adopting them, depending on whether the terms apply by default or not at all.[28]

While LLCs' contractual approach promises efficiency gains if parties are sophisticated, problems arise if some of the owners waive traditional protections without bargaining for substitute safeguards. Doing so can set the stage for later value-destroying opportunism by managers or majority owners. As a consequence, states vary in their willingness to allow LLC waivers of traditional business law protections, based on assumptions about how sophisticated parties are and how contractual freedom is used.[29] States like California, while permitting contractual flexibility for LLCs beyond that available to corporations, nevertheless proscribe owners' and managers' ability to cut back protections. California requires broad fiduciary duties, allowing parties to reduce them only by specifying specific exempt actions and only as long as those actions are not manifestly unreasonable.[30] The Uniform Law Commission's Revised Uniform Limited Liability Company Act, adopted in sixteen states, mandates that LLCs include fiduciary duties of loyalty, care, good faith, a contractual obligation of good faith and fair dealing, and a provision for judicial dissolution of LLCs.[31]

Other states allow more contractual flexibility. New York permits LLC waivers of all fiduciary duties while retaining managers' liability for acts or omissions taken in bad faith or that gave a manager a financial profit to which she is not entitled.[32] Delaware goes further, facilitating almost limitless contractual freedom in the belief that, on

28. Note that no states allow LLCs to waive by operating agreement the terms designed to protect third parties, such as creditors' abilities to force involuntary bankruptcy or pierce the limited liability veil because these third parties are not parties to the operating agreement. *See generally* RIBSTEIN & KEATINGE, *supra* note 13, §§ 3:3, 12:3, 14:4 (discussing third party protections that are either entirely non-waivable or not waivable without the separate consent of third parties). Similarly, federal and state securities laws apply to protect holders of those LLC interests deemed securities, and these securities laws are also not waivable. *See generally* United States v. Leonard, 529 F.3d 83 (2d Cir. 2008) (sustaining a jury's finding LLC ownership interests constitute a security for federal securities laws); CAL. CORP. CODE § 25019 (2001) (explicitly including non-passive LLC interests within state securities laws' purview). *But see* IDAHO CODE § 28-8-103 (2004) (exempting LLC interests from state securities laws).

29. A second important balance that should be kept in mind for LLC statutes is between deciding whether particular terms should even be default terms or instead should not apply unless affirmatively adopted. If the contracting process is relatively costless, then it does not matter whether terms apply by default or must be affirmatively adopted—parties will adopt the appropriate mix. If, on the other hand, the contracting process is not costless, then it becomes an important issue of whether to include various terms by default or instead require parties to adopt them affirmatively, because default terms begin to acquire the characteristics of mandatory ones. *See* Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 3 (2006) (analyzing the mandatory-like attributes of default rules for large corporations); Sandra K. Miller, *The Best of Both Worlds: Default Fiduciary Duties and Contractual Freedom in Alternative Business Entities*, 39 J. CORP. L. 295, 319–24 (2014) (suggesting that bargaining over LLC contract terms is not costless).

30. CAL. CORP. CODE § 17701.10 (c)–(g) (2014).

31. REVISED UNIF. LTD. LIAB. CO. ACT § 110(c) (UNIF. LAW COMM'N 2006) [hereinafter Uniform Act]; *Revised Uniform Limited Liability Company Act Gains Momentum*, LLC ADVISOR (CCH), Dec. 22, 2014 (listing adopting jurisdictions).

32. N.Y. LTD. LIAB. CO. LAW § 417 (2016). The statutory language authorizes waiving only personal liability for fiduciary duty breach, but cases have extended the language to authorize a complete waiver of the fiduciary duty. Pappas v. Tzolis, 982 N.E.2d 576, 599 (N.Y. 2012); Centro Empresarial Cempresa S.A. v. América Móvil, S.A.B. de C.V., 952 N.E.2d 995, 1001 (N.Y. 2011).

balance, the costs of mandatory rules outweigh their benefits. Like other states, Delaware has a host of default protections that apply if the parties to an LLC agreement do not specify otherwise, but the only mandatory term is an implied contractual covenant of good faith and fair dealing, whose purpose is only to ensure the terms of the operating agreement are interpreted as a reasonable person would.[33] Beyond this implied covenant, Delaware allows LLCs to waive protections seemingly without limit, allowing for complete elimination of fiduciary duties, exit rights, and voting rights, for example.[34]

Employing this permissive approach, Delaware has taken the lead in LLC formations as it has with corporate charters.[35] Even though it has been successful in attracting LLC formations, whether Delaware's approach is the optimal one is an open question. For instance, if most LLC agreements attract minority owners that misprice the value of protections, then Delaware's contractual freedom may be used primarily by those looking to opportunistically appropriate gains from uninformed owners. In that case, LLC statutes' reliance on default rather than mandatory protections, exemplified in Delaware's approach, would be problematic as it leads to inefficient governance arrangements and suboptimal firm value. However, if most LLC agreements are the product of bargaining among sophisticated parties who trade over inclusive traditional protections for more finely tuned substitute measures, then LLC statutes' default approach leads to greater efficiency that cannot be replicated with alternative organizational forms. Or finally, if most LLC agreements are governed by the default protections with little modification, then the mandatory/default distinction may matter little.

Whether LLCs use the offered contractual freedom for efficiency, for opportunism, or not at all determines whether relying on merely default rather than mandatory protections is warranted. Unfortunately, because research has yet to show how parties bargain around default provisions, the debate over contractual freedom continues. Before

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33. DEL. CODE ANN. tit. 6, § 18-1101(c), (e) (2013); Uniform Act § 409 cmt. (d); Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. C.A. 3658, 2009 WL 1124451, at *7 (Del. Ch. Apr. 20, 2009) ("Delaware courts rightly employ the implied covenant sparingly when parties have crafted detailed, complex agreements, lest parties be stuck by judicial error with duties they never voluntarily accepted."). The Uniform Model Act goes on to explain that "[t]he obligation of good faith and fair dealing is not a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a partner from acting in the partner's own self-interest. Courts should not use the obligation to change ex post facto the parties' or this Act's allocation of risk and power. . . . [T]he obligation should be used only to protect agreed-upon arrangements from conduct that is manifestly beyond what a reasonable person could have contemplated when the arrangements were made . . . . In sum, the purpose of the obligation of good faith and fair dealing is to protect the arrangement the partners have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it." Uniform Act § 409 cmt. (d). *But see* Douglas M. Branson, *Alternative Entities in Delaware – Reintroduction of Fiduciary Concepts by the Backdoor?*, *in* ELGAR HANDBOOK ON ALTERNATIVE ENTITIES 55 (Mark Loewenstein & Robert Hillman eds., 2015) (arguing that the good faith and fair dealing requirement may be used to reintroduce fiduciary duty concepts in certain circumstances).

34. *See infra* Part IV (providing examples of these waivers).

35. CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 14.01[2] (Warren Gorham & Lamont/RIA eds., 1994) (noting the "almost gravitational pull" that Delaware exerts on LLC law); Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, 55 J.L. & ECON. 741 (2012) (finding that large LLCs overwhelmingly choose Delaware when choosing to form outside their home state); Bruce H. Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91 (finding that most LLCs forming outside their domiciliary state choose Delaware).

turning to my analysis of LLC operating agreements that addresses these issues, I first summarize the existing empirical literature on LLC operating agreement terms and show how they leave unaddressed this central question over default versus mandatory protections.

III. PRIOR STUDIES

Two sets of prior studies have examined the terms in LLC operating agreements. While each advanced the understanding of what a particular type of LLC is doing, neither provides comprehensive evidence for resolving the mandatory/default debate for LLC protections.

The first, initiated by Mohsen Manesh and later expanded upon by Suren Gomtsian, is based on a sample of operating agreements from 12 publicly traded Delaware LLCs.[36] Manesh coded these entities' operating agreements for waivers or liability exculpations of traditional fiduciary duties.[37] He also included mandatory distribution requirements, limited company lifespans, or a right to elect management, each of which is a substitute protection mechanism that can align managers' and owners' incentives.[38] Manesh found routine waivers or exculpations of fiduciary duties,[39] which decrease owner protections, but these were rarely accompanied by significant management-owner alignment via mandatory asset distributions, limited company lifespans, or a right to elect management, let alone all three.[40]

While these findings have helped inform the discussion on LLC regulation and governance, they leave several unresolved issues. For instance, LLCs may compensate for diminished owner protection by adopting substitutes beyond the mandatory distributions, finite lifespans, and the right to elect management that Manesh studied. On the other side of the coin, waiving or eliminating personal liability for fiduciary duties is not the only traditional mandatory owner protection that LLCs are free to eliminate. They might, for instance, do away with the right to seek judicial dissolution, allow opportunistic sales of control by majority owners, or authorize managers to compete directly with the LLC.

Perhaps the greatest limitation of Manesh's work in terms of understanding the typical LLC's operating agreement is that his sample consisted entirely of publicly traded firms whose activities, primarily due to tax considerations, involved almost exclusively passive investments in mineral and natural resource extraction.[41] It is unlikely that the operating agreements of such an unrepresentative sample mirror those of LLCs at large,

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36. Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence From Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555 (2012). In the same study, Manesh also examined 73 publicly traded Delaware limited partnerships, which are governed by a related but distinct set of statutes. Manesh's work was later replicated for the set of publicly traded LLCs using an expanded set of coding variables. Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL. J. CORP. L. 207 (2015).

37. Manesh, *supra* note 36, at 567–69.

38. *Id.* at 569–71.

39. *Id.* at 575–77.

40. *Id.* at 579–81.

41. *Id.* at app. A.

limiting the generalizability of Manesh's work.[42] As examples of just a few reasons to be concerned: managers of publicly traded firms may be more sophisticated than the typical LLC manager, and therefore bargain for relatively lower owner rights; publicly traded firms have difficulty escaping the limelight that may make owner opportunism more difficult;[43] publicly traded firms face takeover threats that constrain the amount of feasible opportunism;[44] publicly traded firms, unlike others, are subjected to investor protections imposed by both stock exchanges[45] and federal securities laws[46] that can substitute for traditional mandatory owner protections; and the operations of firms in mineral and natural resource extraction industries may carry unrepresentative expectations regarding owners' and managers' rights.[47] Finally, publicly traded firms are emblematic of a situation with vulnerable minority owners.[48] Studying solely these firms sheds little light on whether firms with sophisticated owners wield contractual freedom to craft efficient operating agreements, which is essential for fully understanding the mandatory/default debate. From this work, therefore, we cannot reliably discern whether corporate protection reductions are done in the name of efficiency or opportunism.

The second set of studies, originated by Michelle Harner and Jamie Marincic and later expanded by Suren Gomtsian, focused on examining LLC operating agreements available from public SEC filings.[49] Like Manesh's initial study, these studies found widespread use of fiduciary duty waivers and personal liability limitation through exculpation and indemnification clauses, cutting back some of the mandatory corporate owner protections that apply by default to LLCs.[50] Like Manesh's study, however, these conclusions may not be easily generalizable to LLCs at large because of a potentially unrepresentative sample. Operating agreements obtained from SEC filings consist of LLCs where publicly traded companies are an owner (making the operating agreement subject to public SEC filing), leading to larger than average LLCs that had at least one large publicly traded company as an owner.[51] As just discussed, the presence of a

42. Note that Manesh correctly recognizes these generalizability limitations of his sample and does not seek to extend the utility of his findings beyond their proper scope. Manesh, *supra* note 36, at 571–72.

43. Public companies will not only be more likely to attract the attention of financial analysts and news outlets, but they also are subject to various shareholder-rights watchdogs such as the Institutional Shareholder Services organization.

44. *E.g.*, EASTERBROOK & FISCHEL, *supra* note 23, at 231.

45. For example, in addition to minimum listing requirements, the New York Stock Exchange requires that listed companies comply with particular investor safeguards, such as that a majority of the board be comprised of independent directors. NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL §§ 303A.00–.13.

46. Public firms must file various disclosures about their operations, which both provides information about management's performance—making it more likely that opportunism will be discovered—as well as exposes them to antifraud liability. 15 U.S.C. § 78m (2016) (disclosure requirements); *id.* § 78j (general antifraud liability); *id.* § 78r (liability for fraud in filed documents).

47. This final point is particularly likely with respect to the corporate opportunity doctrine, as these passive firms often have professional managers that manage several related organizations and that do not want to be liable to sharing profits among them.

48. *See* EASTERBROOK & FISCHEL, *supra* note 23, at 25.

49. Michelle M. Harner & Jamie Marincic, *The Naked Fiduciary*, 54 ARIZ. L. REV. 879, 898 (2012); Suren Gomtsian, *Contractual Mechanisms of Investor Protection in Non-Listed Limited Liability Companies*, 60 VILL. L. REV. 955, 960 (2015).

50. Harner & Marincic, *supra* note 49, at 907.

51. *Id.* at 898.

publicly traded company as an owner might be expected to skew behavior away from opportunism, so that contractual protections in the operating agreement are less important.[52]

These studies also did not incorporate the full set of protections that can be waived—such as the right to seek judicial dissolution—or the full set of protections that can be added, such as tying management's compensation to the success of the firm.[53] From this analysis, therefore, it is impossible to discern whether the observed reduction in a restricted set of traditional corporate protections is done for efficiency reasons (in which case one might expect substitute protections to be adopted), or whether the reductions were done with an eye towards later opportunism (in which case one would expect no substitute protections to appear).

Therefore, this second study, too, leaves open the question of whether LLC protections should apply only by default or instead should be mandatory. Although the two studies taken together show that specific LLCs regularly modify traditional corporate protections, that fact on its own provides little insight into whether the typical LLC uses contractual flexibility for efficiency or other means. In Part V, I provide the results from my analysis of a new, more complete sample of LLC operating agreements and terms to address this issue.

IV. Empirical Examination of LLC Operating Agreements: Methodology

This Part begins the empirical study of LLC operating agreements. I describe the methodology behind the selection and analysis process. Part V then provides the results of the study.

To draw conclusions about how LLCs as a whole are operating, it is important to begin with as wide and representative a set of LLCs as possible. Because the key to determining how LLCs balance owner and management rights is to study their operating agreements, this key translates into obtaining a broad cross-section of LLC operating agreements. Unfortunately for researchers, these agreements need not be filed with any state agency in the ordinary course of business. Operating agreements are therefore not subject to public inspection through state corporate office records or FOIA requests, nor are they aggregated into useful collections.

In two situations, however, operating agreements are available to the public. The first is when the operating agreement is subject to the public filing requirements of the federal Securities Exchange Act of 1934, either because the LLC itself is a public company or because a public company is a party to the LLC operating agreement.[54] These disclosure requirements are triggered once a company lists on a public securities exchange, engages in a public offering of its securities, or crosses minimum thresholds on asset size (several hundred million dollars) and number of owners.[55] Operating

52. *See supra* notes 43–48 and accompanying text.

53. The initial study by Harner and Marincic focused almost exclusively on fiduciary duties, while Gomtsian later incorporated a more comprehensive set of variables. Harner & Marincic, *supra* note 49, at 899; Gomtsian, *supra* note 49, at 963.

54. 15 U.S.C. § 78m (2016).

55. 15 U.S.C. § 78*l*(a) (2015) (prohibiting brokers or dealers from trading shares on national exchanges unless issuer complies with, among other rules and regulations, 15 U.S.C. § 78m's disclosure rules); *id.* §

agreements can then be readily isolated and obtained from these disclosures, but these entities almost certainly paint a biased picture of what typical LLCs are doing.

The second situation when operating agreements become publicly accessible, and the one utilized in my analysis, arises when parties file them as an exhibit to state or federal litigation. Drawing from this universe of operating agreements yields a rich mixture of large and small firms in diverse industries with both sophisticated and vulnerable owners and managers. However, focusing on these operating agreements brings its own potential biases. First, this sample could potentially underrepresent operating agreements for the smallest LLCs, because tiny businesses may not have enough at stake to make litigating worthwhile. Second, the operating agreements could be more likely to be poorly drafted, or they may not reflect the understanding of the parties if ambiguous agreements or agreements without mutual assent are more likely to be litigated than others. Nevertheless, I decided to use this pool of LLC operating agreements because of its superiority in representing LLCs as a whole. To address concerns about disproportionate levels of poor drafting or understanding, I did not include operating agreements that were incomplete or whose mutual understanding was contested by the parties.[56]

I began by selecting Delaware as the LLC formation state to study. Delaware was chosen for several reasons. First, most LLCs choosing to organize outside of their domiciliary state select Delaware, so focusing on Delaware operating agreements provides a mix of operating agreements from domestic companies as well as more sophisticated foreign firms located outside Delaware.[57] Second, as already discussed, Delaware's LLC law represents the current maximum of contracting freedom. While it supplies several default rules, Delaware imposes practically no consequential mandatory rules on the owner-manager relationship. Examining the agreements that parties strike in this accommodating environment will therefore both provide the best evidence about how traditional corporate owner protections can be traded for substitute safeguards—since the parties are largely free to do whatever they want—as well as provide the most vigorous test of whether sophisticated managers and owners opportunistically induce elimination of minority owner protections by more vulnerable minority owners.

I identified Delaware operating agreements by searching Bloomberg's database of Delaware cases, as well as its database of Delaware dockets for iterations of the phrase "operating agreement" combined with a party name including iterations of the term "LLC." While the results included many false positives, they struck what I felt was an appropriate balance of identifying close to the full universe of available Delaware operating agreements while excluding many spurious results. Research assistants and I then combed through each result's docket to obtain available operating agreements. These agreements were screened for disputes about their validity or mutual

78o(d) (issuers must comply with disclosure rules after a public offering); *id.* § 78*l*(g) (requiring large issuers to file registration statement, in turn subjecting it to disclosure rules).

56. As it turned out, very few operating agreements were excluded because of ambiguity or asserted lack of mutual assent. In fact, most of the operating agreements were not themselves the subject of the litigation. Because there is no overall baseline distribution of LLC size, I could neither identify nor correct for potential undersampling of small LLCs.

57. Kobayashi & Ribstein, *supra* note 35, at 93–94.

understanding, irreconcilable ambiguities, or LLCs with only a single owner.[58] Agreements were also screened so that if substantially identical agreements were included for the same case, as when the same lawyer drafts similar agreements for a series of related entities, only one agreement was included to avoid oversampling of the same effective agreement. Finally, agreements were included only if they were effective in 1997 or later. Significant tax reform that took effect on January 1, 1997 eliminated restrictive requirements for LLCs seeking single taxation of profits, and agreements before the reform could have owner protection terms that were written solely to achieve desirable tax treatment rather than for their protection function.[59]

This process produced an analytical sample of 233 Delaware operating agreements. All were in some way connected to litigation, raising concerns that the sample could be biased in favor of more litigious owners and potentially unrepresentative contracting behavior. However, many operating agreements were only tangentially connected to the underlying dispute, such as when an agreement was attached to a creditor's action to collect on a member's economic interest in the LLC, reducing the bias from any selection effects.

Next, to assess how representative the operating agreements of Delaware LLCs are relative to those formed in other states, I repeated this process with the most recent New York state case dockets to arrive at a sample of 50 LLCs formed within New York. New York served as a useful foil for Delaware, because while its LLC statutory rules are close to Delaware's,[60] the firms choosing to form under New York law are far more likely to be domestic firms, providing a meaningfully different sample to examine.[61]

The resulting LLCs operated in diverse industries, ranging from smaller examples such as local lawn care services and real estate rentals, to large entities like the Quiznos restaurant chain, to publicly traded companies like TravelCenters of America, to obscure

58. Single-owner LLCs do not present the same owner opportunism risk as multi-owner LLCs because the owner and manager are one and the same so that the manager fully internalizes the consequences of owner opportunism. Consequently, the operating agreements for these LLCs have no reason to include any owner protections as with multi-owner LLCs.

59. Under the older "corporate characteristics" regime, LLCs were subjected to corporate double taxation if they had at least three of the four corporate characteristics: continuity of life; centralized management; limited liability; and free transferability of ownership interests. Consequently, LLCs desiring to avoid double taxation would adopt at most two of the above attributes. Effective January 1, 1997, IRS "check the box" regulations allow LLCs to choose whether to be taxed as corporations or partnerships without regard to corporate-like attributes. IRS, *Internal Revenue Manual* § 4.61.5 (May 1, 2006), http://www.irs.gov/irm/part4/irm_04-061-005.html.

60. The two most meaningful differences are that New York does not allow waiving liability for violations of the duty of good faith, and it may not allow waiving the right for owners to seek judicial dissolution. N.Y. LTD. LIAB. CO. LAW § 417 (1996) (prohibiting waivers of liability for good faith); Zulawski v. Taylor, 11 Misc. 3d 1058(A), 2005 WL 3823584, at *10 (N.Y. Sup. Ct. July 1, 2005) (refusing to dismiss a petition for judicial dissolution even though the operating agreement waived the right); *see generally* Youngwall v. Youngwall Realty, LLC, No. 2266-07, 2008 WL 827916 (N.Y. Sup. Ct. Mar. 14, 2008) (refusing to enforce waiver of right to seek judicial dissolution as against public policy). As will be seen, few Delaware LLCs take advantage of this contractual freedom to either exculpate duty of good faith violations or to waive owners' right to petition for judicial dissolution.

61. Kobayashi & Ribstein, *supra* note 35, at 101. In the Delaware sample, only 14% of the firms were domestic, while 100% of the New York firms were domestic (the latter of which likely results from the lack of diversity jurisdiction needed to retain litigation over New York-formed LLCs within New York state court).

firms that made french fry vending machines. I categorized the companies according to the North American Industry Classification System.[62] Table 1 presents the distribution.

62. *North American Industry Classification System,* U.S. CENSUS BUREAU (2012), http://www.census.gov/cgi-bin/sssd/naics/naicsrch?chart=2012.

Table 1
Industry Distribution of Sample

NAICS Code	Description	Del. *n = 233*	N.Y. *n = 50*
11	Agriculture, Forestry, Fishing and Hunting	1% *n = 2*	0% *n = 0*
21	Mining, Quarrying, and Oil and Gas Extraction	2% *n = 5*	0% *n = 0*
22	Utilities	3% *n = 7*	0% *n = 0*
31–33	Manufacturing	7% *n = 17*	0% *n = 0*
42	Wholesale Trade	3% *n = 7*	0% *n = 0*
44–45	Retail Trade	9% *n = 21*	6% *n = 3*
48–49	Transportation and Warehousing	2% *n = 4*	4% *n = 2*
51	Information	3% *n = 8*	6% *n = 3*
52	Finance and Insurance	14% *n = 33*	4% *n = 2*
53	Real Estate and Rental and Leasing	23% *n = 54*	50% *n = 25*
54	Professional, Scientific, and Technical Services	9% *n = 21*	4% *n = 2*
56	Admin., Support, Waste Mgm't, and Remediation Services	6% *n = 15*	2% *n = 1*
62	Health Care and Social Assistance	4% *n = 10*	6% *n = 3*
71	Arts, Entertainment, and Recreation	3% *n = 8*	0% *n = 0*
721	Accomodation	4% *n = 9*	4% *n = 2*
722	Food Services and Drinking Places	4% *n = 10*	12% *n = 6*
812	Personal and Laundry Services	1% *n = 2*	0% *n = 0*

The LLCs covered a wide range of number of owners. Most had relatively few owners, but several had quite large ownership bases, exceeding 1000 owners. Table 2 presents the distribution.

Table 2
Number of Members

Range	Delaware	New York
2	34% *n = 80*	38% *n = 18*
3–5	44% *n = 101*	45% *n = 21*
6–10	9% *n = 101*	9% *n = 21*
11–20	6% *n = 14*	4% *n = 2*
21–50	4% *n = 9*	4% *n = 2*
51+	3% *n = 8*	0% *n = 0*

I then examined each of these operating agreements individually, coding them for various terms coincident with expanding or diminishing owner protections both directly and indirectly.[63] When possible, I also coded the Delaware operating agreements for whether it appeared minority owners were more likely to have been unsophisticated or vulnerable in the operating agreement bargaining context. One can think of several potential ways to differentiate. For example, we could look at the apparent sophistication of the operating agreement itself to determine whether it was likely drafted by specialized legal counsel. The problem with assessing parties' sophistication based on the operating agreement's terms is that sophisticated parties could easily draft what looks like an unsophisticated operating agreement—or unsophisticated parties might nevertheless hire expert legal counsel.[64] Or we might decide that owners who held investments directly

63. Contractual terms related to the dispute resolution process are discussed separately. *See* Peter Molk & Verity Winship, *LLCs and the Private Ordering of Dispute Resolution*, 41 J. CORP. L. 795 (2016).

64. Sophisticated parties may do so if they can rely on non-contractual safeguards to avoid opportunism, such as a repeat relationship or identifiable reputation among the parties. *See, e.g.*, Lisa Bernstein, *Beyond Relational Contracts: Social Capital and Network Governance in Procurement Contracts*, 7 J. LEGAL

through a limited liability investment vehicle rather than directly in their individual capacity might be less likely to seek sophisticated legal representation.[65] The problem with this approach is that it tells us little about those agreements whose owners are pure firms, rather than individuals investing through personal investment entities. It may not even be a reliable indicator for sophistication in those cases where the investing firm is an investing vehicle for an individual because it implies only that that individual likely had sophisticated advice at one time, rather than with respect to the operating agreement at issue.

Ultimately, I based the decision on the amount of capital invested into the firm. Minority owners with less money at risk were assumed to have sought correspondingly less sophisticated counsel (perhaps no counsel at all) and, therefore, would have received less vigorous protection of their owners' interests and allowed for greater potential opportunism by managers or majority owners.[66] However, the presence of one such owner might not result in weak minority owner protections; other minority owners with more capital at risk might nevertheless bargain for sufficient safeguards. I therefore tailored the standard to identify when potentially vulnerable owners held enough assets to make opportunism by majority owners worthwhile. An LLC was deemed to involve more vulnerable owners if, based on my analysis, it had owners who invested less than $100,000 each but collectively held greater than a 10% share, which results in a substantial collective stake held by minority owners such that the rewards to majority opportunism are relatively large. Additionally, LLCs were coded as having more vulnerable owners if a single owner held more than a 90% share, with remaining owners investing under $100,000 each, which identifies a situation where rewards to majority opportunism are relatively lower but minority rights are particularly unlikely to be protected.[67] These criteria resulted in 159 LLCs being deemed to have less vulnerable owners, 50 having more vulnerable owners, and 24 that could not be classified. While adopting this particular threshold was the product of experience and discussion with various practitioners in this area, the principal findings were robust to other financial specifications ranging from 1% to 20% owners investing $10,000 to $250,000.

V. EMPIRICAL EXAMINATION OF LLC OPERATING AGREEMENTS: RESULTS

This Part provides the analysis of Delaware and New York operating agreements. I begin by looking at provisions that weaken owners' protections and then turn to provisions that strengthen these protections.

ANALYSIS 561, 563 (2015) (examining non-contractual devices used by sophisticated parties to avoid opportunism).

65. Investors would invest through corporate investment vehicles to shield their investments from their personal creditors. *See generally* Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006) (focusing on the importance of this entity shielding).

66. Sandra Miller has found variation in legal cognizance of basic LLC issues, suggesting that hiring more novice or cut-rate representation could produce significantly weaker owner protection in the realm of LLCs. *See generally* Sandra K. Miller et al., *An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609 (2006); Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. CAL. L. REV. 351 (2003).

67. For these criteria, I also included investments of cash equivalent, such as sweat equity. Four firms that were set up for the benefit of minors and other family relatives were treated as unclassified because of the presumed initial non-adversarial relationship that could affect the bargaining process.

A. Weakening Protections

Several protections from corporate law have been imported into the law of LLCs. In Delaware and New York, these protections generally apply to LLCs by default and can be waived by the parties if desired; in other states, they may apply by default or may be mandatory, non-waivable rules. This Section examines the prevalence of weakening or completely dispensing with these protections in LLC operating agreements. While seemingly an unintuitive action to take, it could be to the benefit of the LLC as a whole, and, therefore, to its owners, to cut back these protections if owners are able to protect themselves in other ways. The worry, of course, is that rollbacks of owner protections may be merely a means for sophisticated managers or controlling owners to expropriate welfare from the less informed.

1. Authorizing Competition

LLC managers are precluded by default from engaging in external activities that compete with the LLC's business.[68] The requirement for managers not to compete with the LLC comes out of the fiduciary duty of loyalty, discussed more fully in Section 3.

Consonant with the belief in contractual freedom, parties to Delaware and New York LLC operating agreements are able to waive this protection.[69] Doing so clearly undermines owners' protection against potential opportunism by managers, but the waiver could be desirable if owners are otherwise protected and the waiver authorizes a mutually beneficial bargain. For example, investment managers often manage a series of funds organized as separate entities, and a prohibition against their engaging in competing activities could greatly increase the costs they would charge in management fees. Waiving this protection could collectively save owners more than the protection is worth to them.

Table 3 collects the results on waiving managers' prohibition against competition. The results aggregate full and partial waivers together; only six agreements contained a partial waiver of the prohibition against competition. As can be seen, waivers are not uncommon, occurring in 40% of Delaware LLCs. The rate is insignificantly lower among New York LLCs, occurring in 38% of the operating agreements. Within Delaware, the difference was largely invariant to whether parties were likely to have been represented by sophisticated counsel. Thirty-nine percent of LLCs with less vulnerable owners waived managers' duty not to compete, while 40% of LLCs with more vulnerable minority owners less likely to hire sophisticated representation did so.

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68. *E.g.*, UNIF. LTD. LIAB. CO. ACT § 409(a), (g) (UNIF. LAW COMM'N 2006) (applying to member-managed and manager-managed LLCs, respectively).

69. N.Y. LTD. LIAB. CO. LAW § 417 (2006) (authorizing waivers of the duty of loyalty and thus the subsumed duty not to compete); *see, e.g.*, Cantor Fitzgerald L.P. v. Cantor, No. C.A. 16297, 1998 WL 326686 (Del. Ch. June 16, 1998); Centro Empresarial Cempresa S.A. v. America Móvil, S.A.B. de C.V., 952 N.E.2d 995, 1001–02 (N.Y. 2011) (enforcing waivers).

Table 3
Waiver of Duty Not to Compete

Delaware (total sample), n = 233	40% *n = 94*
…less vulnerable, n = 158	39% *n = 62*
…more vulnerable, n = 50	40% *n = 20*
New York (total sample), n = 50	38% *n = 19*

2. Waiving the Business Opportunity Doctrine

Related to managers' duty not to compete is the business opportunity doctrine, which bars managers and controlling shareholders from seizing projects for themselves that would benefit the LLC. Like the prohibition against competition, the business opportunity doctrine (or the corporate opportunity doctrine counterpart in corporate law)[70] is a particular manifestation of the duty of loyalty, which is discussed more fully in the next Section.

Whether a project constitutes a business opportunity is measured by balancing several factors—including whether the firm is financially able to undertake the opportunity, whether the opportunity is in the firm's line of business, whether the firm has a reasonable expectancy in the opportunity, and whether the manager would have a conflict between her self-interest and her duty to the LLC as a result of seizing the opportunity.[71]

Patently, a waiver of the business opportunity doctrine undermines the protection of LLC owners. Legally, managers would be free to capture all profitable investments for their own account rather than share them with the LLC, leaving the LLC an empty shell that earns no profit. Of course, just because conduct has no legal sanction does not mean managers will engage in it; social norms, shaming, not being fired, and the desire to maintain a good reputation also deter behavior. And if these deterrents are sufficient, waiving the business opportunity doctrine may make sense. With poorly defined contours, the doctrine generates legal uncertainty that could overdeter (or underdeter) desirable behavior by managers, not to mention produce sizable litigation expense.[72] In other words, the protection offered by the business opportunity doctrine comes with costs.

70. For comparisons between the business opportunity doctrine and its corporate analogue, see RIBSTEIN & KEATINGE, *supra* note 13, at § 9:3.

71. Broz v. Cellular Info. Sys., 673 A.2d 148, 154–55 (Del. 1996).

72. Talley, *supra* note 17, at 279 (describing the doctrine as "provid[ing] little guidance either to theorists or to practitioners").

Consequently, as they do with the duty not to compete, Delaware and New York authorize waivers of the business opportunity doctrine for LLCs.[73] As Table 4 shows, 40% of Delaware LLCs take advantage of the contractual freedom to do so, with no significant difference between LLCs with and without vulnerable minority owners. Among the sample of New York LLCs, 42% waive the business opportunity doctrine.

Table 4
Waiver of Business Opportunity Doctrine

Delaware (total sample), n = 233	41% *n = 95*
…less vulnerable, n = 158	41% *n = 65*
…more vulnerable, n = 50	34% *n = 17*
New York (total sample), n = 50	42% *n = 21*

3. Modifications of Traditional Fiduciary Duties

The concept of fiduciary duties pervades all areas of business organization law. Agents owe fiduciary duties to their principals. Partners owe fiduciary duties to their partnership and one another. Directors and officers owe fiduciary duties to their corporation. For LLCs, managers, and potentially members, may owe fiduciary duties to the LLC.

Fiduciary duties act as a judicial backstop for when legal rules, contractual terms, and market discipline are insufficient to deter destructive behavior.[74] Delaware, New York, and most other jurisdictions recognize three fiduciary duties: loyalty, care, and good faith.[75] Under the duty of loyalty, the fiduciary must avoid self-dealing; she cannot benefit to the detriment of the organization.[76] In addition, to a general bar on self-dealing, the duty of loyalty has expanded to include a prohibition on competing with the firm via one's other activities as well as a prohibition against claiming corporate opportunities for oneself.[77] The duty of care requires that the fiduciary carry out her responsibilities in a manner that avoids gross negligence or worse.[78] This obligation means that, among other things, the fiduciary must make business decisions in an informed manner and not ignore

73. *See generally Broz*, 673 A.2d 148; Pappas v. Tzolis, 982 N.E.2d 576 (N.Y. 2012).

74. *E.g.*, D. Gordon Smith, *Doctrines of Last Resort*, *in* REVISITING THE CONTRACTS SCHOLARSHIP OF STEWART MACAULAY: ON THE EMPIRICAL AND THE LYRICAL 426, 427 (Jean Braucher et al. 2013) (referring to fiduciary duties as a "doctrine of last resort" once contractual and other explicit safeguards fail).

75. TAMAR FRANKEL, FIDUCIARY LAW 101–07 (2011).

76. *E.g.*, RIBSTEIN, *Fencing Fiduciary Duties*, *supra* note 7, at 908.

77. *See supra* note 17 and accompanying text.

78. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 53 (Del. 2006).

her responsibilities as a fiduciary.[79] Finally, the duty of good faith, as its name would suggest, requires that fiduciaries carry out their responsibilities honestly and in good faith. The legal indicators of conduct that violates the duty of good faith are bad faith, willful or intentional misconduct, or knowing violations of the law.[80]

Recognizing the overlap among these protections and the fact that sophisticated parties may be better off eliminating fiduciary duties, Delaware and New York allow LLC parties to waive them, although fiduciary duties apply by default.[81] If parties want to soften some of a fiduciary duties' bite but not go as far as a complete waiver, another option is to exculpate owners' and managers' personal liability for violating specified fiduciary duties. Exculpating personal liability without waiving fiduciary duties leaves fiduciary duties intact but restricts the remedies that aggrieved parties can seek to non-monetary options.[82] These options include "injunctive relief, a decree of specific performance, recission, the imposition of a constructive trust, and a myriad of other non-liability-based remedies."[83] Taking monetary damages off the table, however, decreases the chances that fiduciary duty suits will be brought because the typical motivator—money damages—is not available when confronted with an exculpation clause. Both Delaware and New York authorize exculpating breaches of fiduciary duty.[84]

Finally, parties seeking a third option can indemnify breaches of fiduciary duties, which commits the LLC to reimbursing managers' costs associated with a breach. Under an indemnification agreement, while the manager remains personally liable for the costs of a fiduciary duty breach, the manager is entitled to be reimbursed from the LLC for this personal liability.[85]

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79. *See generally* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

80. *E.g.*, *Disney,* 906 A.2d at 67. Delaware has subsumed this duty within the duties of loyalty and care, using it to brand particularly egregious examples of duty of loyalty violations; it is unclear whether other jurisdictions similarly treat the duty of good faith as an independent fiduciary duty. *See generally* Stone v. Ritter, 911 A.2d 362 (Del. 2006).

81. N.Y. LTD. LIAB. CO. LAW § 409 (1994); DEL. CODE ANN. tit. 6, §§18-1101(c)–1104 (2013). Section 1104, amended in 2013 to say that fiduciary duties apply by default, made clear what the Chancery Court had previously held and what litigants took for granted. *See* Mohsen Manesh, *Damning Dictum: The Default Duty Debate in Delaware*, 39 J. CORP. L. 35, 37, 41–46 (2013) (describing a variety of sources reflecting the same understanding); *see generally* Auriga Capital Corp. v. Gatz Properties, 40 A.3d 839 (Del. Ch. 2012) (holding fiduciary duties apply to LLCs by default); William Penn P'ship v. Saliba, 13 A.3d 749 (Del. 2011) (mentioning that parties agree that managers of LLCs owe traditional corporate fiduciary duties unless expressly modified or waived); Feeley v. NHAOCG, LLC, 62 A.3d 649 (Del. Ch. 2012). Like Delaware, New York allows fiduciary duty waivers and exculpation absent a final judgment of bad faith or obtaining an illegal financial profit or entitlement. *See supra* note 32 and accompanying text. Fiduciary duties apply by default. *E.g.*, *In re* Die Fliedermaus LLC, 323 B.R. 101, 110 (Bankr. S.D.N.Y. 2005); Melcher v. Apollo Med. Fund Mgmt. LLC, 923 N.Y.S.2d 92, 93 (N.Y. App. Div. 2011).

82. *E.g.*, *Feeley*, 62 A.3d at 664.

83. *Id.*

84. DEL. CODE ANN. tit. 6, § 18-1101(e); *supra* note 81 and accompanying text. New York's statute requires that bad faith not be exculpated, although as discussed above, the precise contours of the duty of good faith outside Delaware are not clearly defined. N.Y. LTD. LIAB. CO. LAW § 417 (1995); *supra* note 80 and accompanying text.

85. Indemnification agreements can also advance expenses to managers, which alters the timing but not the substance of the indemnification agreement.

If the company is solvent and has no insurance to cover managers' liability,[86] then an indemnification clause acts like a species of exculpation: managers pay damages to the LLC for the fiduciary duty breach, and the LLC in turn pays this back to managers as a reimbursement. Indemnification then goes a step beyond exculpation by also covering managers' litigation expenses. But if the company is insolvent, indemnification can be a stronger deterrent to managers than exculpation by not being available to reimburse managers.[87] And to be indemnified, managers must first incur legal expenses, meaning they must proceed through the litigation process. Having to defend oneself in the public courtroom to later be indemnified can be less attractive than exculpation, which closes the door on lawsuits much earlier in the process if those suits seek financial damages from the manager.

Delaware authorizes LLCs to indemnify managers without limit. New York permits operating agreements to authorize indemnification absent a final adjudication that the manager acted in bad faith or gained an advantage or profit to which she was not legally entitled.[88]

Waiving, exculpating, or indemnifying breaches of fiduciary duties clearly undermines the protection that LLC owners have against managers and the actions of other owners. Table 5 shows that these waivers, exculpations, and indemnifications are common among LLCs with either more or less vulnerable owners, with modifications to the duty of loyalty significantly more common among Delaware LLCs with less vulnerable owners.[89] Both the Delaware and New York samples followed similar patterns. Table 6 provides information about solely indemnification, showing that the

86. Directors and officers insurance is sold to cover precisely these circumstances, but these policies may have exclusions rendering them unavailable—as, for instance, an exclusion in the corporation context that excludes insurance coverage for actions brought by current or former directors. Of course, insurance would also be unavailable if it were never purchased.

87. When the LLC is insolvent, it cannot reimburse managers' expenses so that managers bear the financial costs of a fiduciary duty breach. While this situation will not produce a net recovery to owners, it will deter fiduciary duty breaches—perhaps at a time when those breaches are most likely, as being in the zone of insolvency increases managers' incentives to take risks, including expropriating LLC assets from owners who have nothing to lose. *See, e.g.*, Credit Lyonnais Bank Nederland v. Pathe Commc'ns Corp., C.A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) (recognizing the incentive for managers to gamble with creditors' money when near insolvency). As managers are answerable to owners and as owners' claims have no value when the LLC is insolvent, it is not unreasonable to suppose that managers will likewise be more inclined to breach fiduciary duties when near insolvency and for owners to remain relatively indifferent to this breach. *See* WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 3–4 (Feb. 1, 2002) (describing members of Enron tunneling money in a series of transactions while Enron was near insolvency).

88. DEL. CODE ANN. tit. 6, § 18-108; N.Y. LTD. LIAB. CO. LAW § 420.

89. The operating agreement was deemed to modify the duty of loyalty if it referred to the duty of loyalty explicitly, required managers to act in a way she reasonably believed to be in (or at least not opposed to) the LLC's interests, prohibited improper takings, or used similar formulations. *See* Leo E. Strine Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 658–59 (2010) (associating this latter language with the duty of loyalty under Delaware law); *see generally* OH. REV. CODE ANN. § 1701.59(D)(1) (associating the duty of loyalty with this standard). The duty of good faith was deemed modified if the operating agreement modified the duty of good faith explicitly or any of that duty's hallmarks: bad faith, willful or intentional misconduct, or intentional violations of the law. *See supra* note 80 and accompanying text. Finally, I determined that operating agreements modified the duty of care if they explicitly referenced the duty of care or its typical judicial counterpart, gross negligence or recklessness. *See supra* note 78 and accompanying text.

prevalence of indemnifying fiduciary duty breaches generally follows the same pattern as waiving, exculpating, or indemnifying them.

Table 5
Fiduciary Duty Modification

	Loyalty*	Good Faith	Care
Delaware (complete waiver)	4% *n = 9*	3% *n = 7*	3% *n = 8*
…less vulnerable	4% *n = 7*	4% *n = 6*	4% *n = 7*
…more vulnerable	4% *n = 2*	2% *n = 1*	2% *n = 1*
…not waived; exculpated	37% *n = 87*	5% *n = 12*	23% *n = 53*
…less vulnerable	39% *n = 62*	4% *n = 7*	21% *n = 33*
…more vulnerable	26% *n = 13*	6% *n = 3*	24% *n = 12*
…not waived or excul.; indemnified	22% *n = 52*	10% *n = 23*	19% *n = 45*
…less vulnerable	23% *n = 37*	10% *n = 16*	17% *n = 27*
…more vulnerable	20% *n = 10*	8% *n = 4*	26% *n = 13*
Total (waived, exculpated, or indemnified)	64% *n = 148*	18% *n = 42*	45% *n = 106*
…less vulnerable	67% *n = 106*	18% *n = 29*	42% *n = 67*
…more vulnerable	50% *n = 25*	16% *n = 8*	52% *n = 26*
New York (complete waiver)	6% *n = 3*	2% *n = 1*	2% *n = 1*
…not waived; exculpated	34% *n = 17*	0% *n = 0*	16% *n = 8*
…not waived or excul.; indemnified	26% *n = 13*	22% *n = 11*	28% *n = 14*
Total (waived, exculpated, or indemnified)	66% *n = 33*	24% *n = 12*	46% *n = 23*

*References to the duty of loyalty do not include modifications of solely the duty not to compete or of the business opportunity doctrine. While both fall within the duty of loyalty, they are broken out separately in the prior subparts.

Table 6
Indemnification

	Loyalty	Good Faith	Care
DE (total sample), n = 233	52% *n = 120*	11% *n = 26*	37% *n = 86*
…less vulnerable	56% *n = 89*	11% *n = 18*	35% *n = 55*
…more vulnerable	38% *n = 19*	8% *n = 4*	42% *n = 21*
NY (total sample), n = 50	56% *n = 28*	22% *n = 11*	36% *n = 18*

Tables 7 and 8 provide information on conditional probabilities—the chance that one or more other fiduciary duties will be waived, exculpated, or indemnified given that a fiduciary duty has already been modified. The conditional probabilities vary substantially by fiduciary duty. Two generalized conclusions immediately emerge: first, if at least two fiduciary duties are modified, it is almost a guarantee that the third fiduciary duty will also be modified. Second, operating agreements that modify the duty of good faith are extremely likely to modify both other fiduciary duties—although modifications to the duty of good faith are relatively rare in the first instance.[90]

90. *Supra* tbl. 5.

Table 7
Conditional Duty Modification (Delaware)

Conditional on This Duty(ies) Being Modified.. / Is This Duty(ies) Modified?	L	GF	C	L & GF	L & C	GF & C
Loyalty (L)*		26% *n = 38*	52% *n = 77*			26% *n = 38*
Good Faith (GF)	90% *n = 38*		93% *n = 39*		90% *n = 38*	
Care (C)	73% *n = 77*	37% *n = 39*		36% *n = 38*		
Loyalty & Good Faith			100% *n = 38*			
Loyalty & Care		100% *n = 38*				
Good Faith & Care	97% *n = 38*					

*References to the duty of loyalty do not include waivers of either the duty not to compete or of the business opportunity doctrine. While both fall within the duty of loyalty, they are broken out separately in the prior subparts.

Table 8
Conditional Duty Modification (New York)

Conditional on *This* Duty(ies) Being Modified..	Is *This* Duty(ies) Modified?					
	L	GF	C	L & GF	L & C	GF & C
Loyalty (L)*		36% *n = 12*	61% *n = 20*			36% *n = 12*
Good Faith (GF)	100% *n = 12*		100% *n = 12*		100% *n = 12*	
Care (C)	87% *n = 20*	52% *n = 12*		52% *n = 12*		
Loyalty & Good Faith			100% *n = 12*			
Loyalty & Care		100% *n = 12*				
Good Faith & Care	100% *n = 12*					

*References to the duty of loyalty do not include waivers of either the duty not to compete or of the business opportunity doctrine. While both fall within the duty of loyalty, they are broken out separately in the prior subparts.

a. Drag-Along Rights

Drag-along rights allow a particular owner, typically the holder of a majority ownership stake, to force other owners to proceed with a sale of the company on the same terms received by the majority owner and, thereby, eliminate minority owners' power to hold up deals.[91] Drag-along rights are a common fixture among venture capital deals, appearing in approximately three quarters of major deals.[92]

Owners' valuations of their ownership stakes can vary for a variety of reasons. Some may have higher discount rates or shorter time horizons than others.[93] They may

91. For an example of a drag-along right, see Nat'l Venture Cap. Ass'n, *Amended and Restated Voting Agreement* 5–10 (Mar. 2014), http://nvca.org/?ddownload=387. Statutes typically require at least supermajority consent to mergers. *See, e.g.*, Uniform Act § 1003 (requiring unanimous owner consent to merger). One can see that drag-along rights therefore effectively alter this rule to one that authorizes mergers and acquisitions solely with the consent of the owner holding the drag-along rights.

92. Cooley LLP, *2014 Venture Financing in Review*, COOLEY VENTURE FINANCING REPORT 6 (2015), https://www.cooley.com/~/media/cooley/pdf/venture-financing-reports/cooley-vf2014q4.ashx?la=en.

93. This difference was particularly dramatic in the recent Delaware Chancery Court case *In re* Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013) (applying the entire fairness standard to a change of control transaction that benefited venture capital preferred shareholders but not common shareholders); see generally

differ about the firm's future prospects. Founders and owner-employees of the company may have idiosyncratic or employment-related reasons to resist sales. Sellers of majority stakes may be receiving a side deal whose value cannot be captured by other selling owners, such as the promise of a lucrative employment deal. Because sales of the company require the approval of ownership interests, sales can get held up or even scuttled when owners disagree over the value of the firm.[94] Drag-along rights solve this issue by having the parties agree upfront to follow the desires of the rights' holders.

However, committing to follow the wishes of the drag-along rights' holders can involve a loss of protection for the remaining owners. In circumstances when the rights holders are selling on terms the other owners want anyway, the rights are effectively close to worthless; the transaction would have happened even without issuing the rights. When at least some minority owners disagree with the selling terms, such as for the reasons discussed above, drag-along rights represent a loss of protection for these minority owners.[95]

Drag-along rights are not unique to large venture capital-backed deals. Table 9 shows their prevalence in LLC operating agreements. While the rights are less common than in large deals, they still feature in a quarter of all LLC operating agreements. The rights were significantly more prevalent among Delaware LLCs with less vulnerable owners and among Delaware LLCs compared to New York LLCs.

Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law*, 66 CASE W. L. REV. 51 (2015) (analyzing the implications from investors with conflicting time horizons).

94. For discussions of these and other reasons for including drag-along rights, see Brian Broughman & Jesse M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319, 1331–35 (2013).

95. Even if the votes by the holders and non-holders would be sufficient to approve a sale, the requirement that dissenting owners also vote for the deal could still be valuable, as it forecloses their appraisal rights. *Id.* at 1330–31.

Table 9
Prevalence of Drag Along Rights

Delaware (total sample), n = 233	24% *n = 57*
…less vulnerable, n = 158	28% *n = 44*
…more vulnerable, n = 50	12% *n = 6*
New York (total sample), n = 50	10% *n = 5*

b. Judicial Dissolution

LLC statutes provide owners of problematic LLCs the option to seek a remedial order of judicial dissolution, which dissolves the LLC and distributes its assets to owners. Obtaining an order of dissolution requires showing that it is no longer "reasonably practicable" to carry on the LLC's business along the terms indicated in its operating agreement—as, for instance, if management is deadlocked or minority owners are suffering systematic exploitation.[96] Seeking an order of judicial decree therefore acts as a nuclear option available to LLC owners when other options fail.

Judicial dissolution can provide a valuable safeguard to owners. By default, owners' interests are neither transferable nor withdrawable, tethering owners to the LLC for good or for bad, giving rise to potential opportunism familiar to those who study closely held organizations. With no exit rights for minority owners, majority owners have entrenched themselves as managers; paid themselves excessive salaries; both refused to distribute accrued earnings or distributed too much earnings; refused potential takeovers or buyouts preferred by the other owners; and engaged in a host of other behavior to transfer money from other owners to themselves.[97] The potential opportunism may be even more severe with LLCs. Owners are not only prohibited from withdrawing their ownership stake by default but also are prohibited from withdrawing *at all* from the LLC, even if they are willing to sacrifice any accrued ownership value.[98] Furthermore, as we have seen, minority owner protections can be significantly weaker for LLC owners than owners of other business organizations, given LLCs' unique freedom to waive traditional owner

96. DEL. CODE ANN. tit. 6, § 18-802 (1992); N.Y. LTD. LIAB. CO. LAW § 702 (McKinney 1994); Uniform Act § 701(a)(4); RIBSTEIN & KEATINGE, *supra* note 13, § 11.5.

97. *E.g.*, Douglas K. Moll, *Minority Oppression & The Limited Liability Company: Learning (or not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883 (2005) (analyzing these problems).

98. Reasons to withdraw, even if doing so forfeits accumulated value, include the desire to avoid being held personally liable for the LLCs debts via piercing the corporate veil, as well as the desire to remove any fiduciary responsibilities to the LLC, particularly the corporate opportunity doctrine's requirement that opportunities be shared with the LLC if appropriate. *See supra* Section IV.A.2 (discussing the corporate opportunity doctrine and associated waivers and modifications).

protections. A last ditch judicial dissolution effort can be extremely valuable in these circumstances.

Nevertheless, there are legitimate reasons why LLC parties may be better off by waiving the right to seek judicial dissolution. First, doing so increases the credibility of the parties' commitment to the LLC, its operating agreement, and one another; judicial dissolution no longer provides relief when things get difficult. Such a commitment can send a mutual signal of trust and encourage a good working relationship.[99] Second, judicial dissolution can be harmful to the business as a whole; for example, loan agreements commonly have covenants under which judicial dissolution triggers a noncurable event of default.[100]

In the right circumstances, then, a waiver of the right to seek judicial dissolution can enhance the LLC's value, but the ramifications of a waiver can be severe if less sophisticated owners are involved. Consequently, the Model Act and several states view the right to seek judicial dissolution as a mandatory right that cannot be waived.[101] Lower courts in New York have followed suit and held judicial dissolution to be a nonwaivable right.[102] Delaware, however, authorizes waivers of judicial dissolution, taking the view that benefits to sophisticated parties outweigh costs to the less sophisticated.[103]

Table 10 collects the results on the prevalence of waivers of the right to seek judicial dissolution. Overall, waivers of the right to seek judicial dissolution are uncommon, reflecting the fundamental value that parties place in it. Waivers occur in 12% of all Delaware LLCs, with small variation between those firms with and without vulnerable owners. Interestingly, the right to seek judicial dissolution was waived in 8% of New York LLCs, despite its demonstrated lack of enforceability there.[104]

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99. *See generally* Blair & Stout, *supra* note 23, at 1774–75.

100. R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, C.A. No. 3803-CC, 2008 WL 3846318, at *7 (Del. Ch. Aug. 19, 2008); RIBSTEIN & KEATINGE, *supra* note 13, § 11:5.

101. Uniform Act § 110 (c)(7); RIBSTEIN & KEATINGE, *supra* note 13, § 11:5 (listing other states where the right to seek judicial dissolution cannot be waived).

102. Youngwall v. Youngwall Realty, No. 2266-07, 2008 WL 827916 (N.Y. Sup. Ct. Mar. 14, 2008).

103. DEL. CODE ANN. tit. 6, § 18-1101(c) (2013) (promoting contractual freedom); *R & R Capital*, 2008 WL 3846318, at *8 (enforcing waiver of right to seek judicial dissolution). The Delaware judiciary has shown some reluctance to allow complete waivers of judicial dissolution, enforcing waivers while at the same time expressing a desire to preserve judicial dissolution as an equitable source of last resort. *See In re* Carlisle Etcetera LLC, 114 A.3d 592 (Del. Ch. 2015); Huatuco v. Satellite Healthcare & Satellite Dialysis of Tracy, LLC, C.A. No. 8465-VCG, 2013 WL 6460898 (Del. Ch. Dec. 9, 2013).

104. The point of including the waiver in these New York operating agreements is presumably to implement waivers automatically should New York courts decide to recognize them or to decrease the attractiveness of seeking judicial dissolution in the first place as judges could always recognize the right upon suit being brought with a contractual waiver.

Table 10
Waivers of Judicial Dissolution Right

Delaware (total sample), n = 233	12% *n = 29*
…less vulnerable, n = 158	14% *n = 22*
…more vulnerable, n = 50	10% *n = 5*
New York (total sample), n = 50	8% *n = 4*

B. Strengthening Protections

The preceding Sections show the ways that LLCs reduce standard protections offered to owners, giving more power to managers and majority owners. As discussed before, this reduction in standard owner protections is not necessarily disconcerting if it is accompanied by the adoption of substitute owner protection mechanisms. The following Sections examine these protections. The first four protections examined directly provide additional rights to owners, while the remaining four indirectly provide owner protections by reducing managerial discretion and aligning management interests with owners'.

1. Amending the Operating Agreement

The rights and protections initially given to LLC owners would not be very effective if they could later be taken away without those owners' input. Consequently, I examined operating agreements to determine whether owners' approval was required to amend the agreements.

Under basic contract law principles, because an operating agreement is a contract among parties, those parties should not be bound to amendments unless they have agreed to them. Extending this reasoning to operating agreements suggests that amendments would require unanimous owner consent. Unanimous consent means that owners' rights are not modified without those owners' consent and would protect minority owners from an opportunistic majority that might otherwise try to eliminate minority protections. Yet achieving unanimous owner approval may involve practical difficulties, particularly for those LLCs with more than a handful of owners, giving legitimate business reasons to allow amendment by less than unanimity. Recognizing this difficulty, Delaware, New York, and the Uniform Act allow LLCs to amend their operating agreements with less than unanimous owner consent.

Delaware and the Uniform Act enforce the amendment procedures that appear in the operating agreements—no statutory default procedure is provided.[105] New York also enforces operating agreement amendment procedures against a background default of consent by every adversely affected owner.[106] Almost every operating agreement in my sample explicitly addressed how it could be amended. Table 11 shows the cumulative distribution of the ownership vote necessary to make substantive amendments to the operating agreement.[107] Most common by far was a provision requiring unanimous owner vote, but amendment by less than unanimous owner approval occurred in one-third of Delaware operating agreements and one-quarter of New York operating agreements. One operating agreement even provided for amendment without owner approval of any sort.[108]

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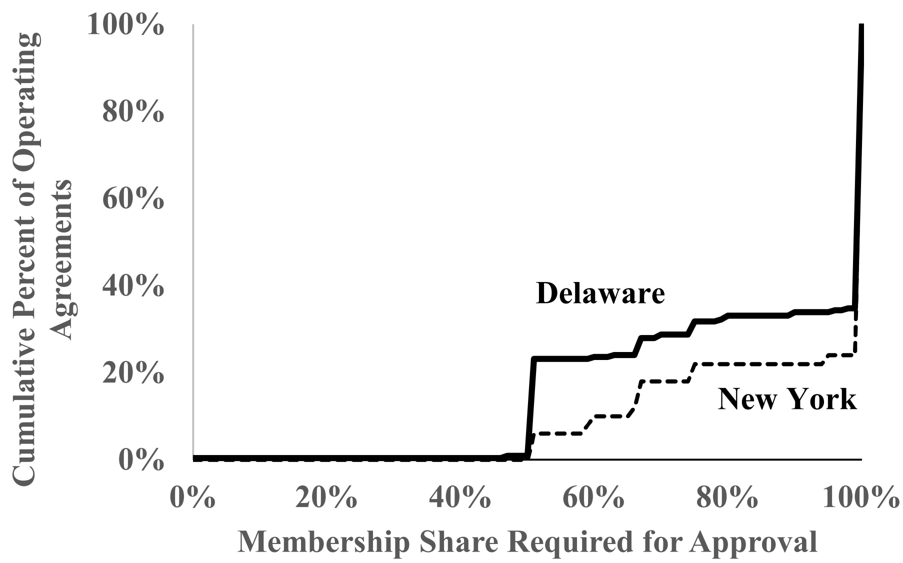
105. Uniform Act § 18-110(a). The Delaware statute includes no provision for how the operating agreement must be amended. Because no default procedure is provided, for the analysis I assumed that those Delaware operating agreements not specifying an amendment procedure required unanimous owner consent for amendment, consistent with basic contract law principles. *Cf.* DEL. CODE ANN. tit. 6, § 17-302(f) (2016) (unanimous consent default rule for amending limited partnership operating agreements).

106. N.Y. LTD. LIAB. CO. LAW § 417(b) (1994).

107. Operating agreements commonly allow management to make unilateral amendments to the operating agreements as long as these amendments are not substantive in nature, such as amendments to reflect changes to the identity of owners, or amendments necessary for compliance with securities laws. *See, e.g.*, Amended and Restated Limited Liability Company Agreement of Seminole Night Club LLC (Sept. 22, 2004), § 12.4. For those operating agreements requiring just the consent of managers without owner approval, I "looked through" the management clause to see the ownership share, if any, that managers held. For example, an operating agreement requiring the majority consent.

108. Amended and Restated Operating Agreement of PJM Interconnection, LLC (July 14, 2011), § 8.1 (allowing amendment with approval of management and owner committee comprised of representatives of the hundreds of owners). Because PJM is subject to federal oversight and substantial regulation by the Federal Energy Regulatory Commission, the requisite owner protection may be supplied by these alternative means.

Figure 11
Amendment of Operating Agreements



2. Transferability

In closely held organizations, the identity of owners can be extremely important. This importance can be because the owners also have a role in managing the firm, because owners were specifically selected to share a common vision with management, because the firm is a family business, or for a myriad of other reasons. Because of the importance of owner identity to these closely held organizations, they commonly do not provide for free transferability of shares, which instead is found in large corporations where the particular identity of owners is unimportant.[109]

Transfer restrictions also serve as a minority protection device for both closely held and large firms. When transfers can be blocked by minority owners, controlling owners are prohibited from opportunistically selling their control stakes to a new group that may expropriate welfare from minority shareholders. Of course, broad transfer restrictions also mean that minority owners will not be able to sell their position if they find themselves systematically abused by the majority, but the right to sell in these circumstances is not particularly valuable anyway—minority shares will trade at a discount if minority owners find themselves in such an unfortunate position.

LLC statutes, built on the closely held firm framework, provide a default rule that restricts transfers to rights to receive economic distributions only. Transferring the full rights of ownership, including voting rights, requires the approval of nontransferring

109. *E.g.*, Hansmann et al., *supra* note 65, at 1350.

owners.[110] Because of the value from liquidity arising with free transferability, however, both Delaware and New York allow the default rule to be overridden, trading off owner protections against other potential benefits.

Most firms follow the default provision to restrict free transferability. Table 12 summarizes the percent of firms that restrict transfers beyond bare economic interests by at least the majority owners.[111] Fully three–quarters of Delaware operating agreements include such a provision; the prevalence did not vary between firms with and without vulnerable owners. The rate of restrictions was even higher among New York LLCs, with 86% including a restriction. Additionally, even for those firms that included a right to transfer, the operating agreement typically provided either the firm or the non-transferring owners (or both) with a first refusal right to purchase any shares that would be transferred, further protecting the stability of owners' identity.[112]

Table 12
Restrictions on Transfers by Majority

Delaware (total sample), n = 233	75% *n = 174*
…less vulnerable, n = 158	76% *n = 120*
…more vulnerable, n = 50	78% *n = 39*
New York (total sample), n = 50	86% *n = 43*

3. Withdrawal Rights

A potentially powerful weapon owners have against the threat of opportunism is to withdraw the value of their ownership stake and exit the firm—assuming they are allowed to exit.[113] Rational owners and managers who require assets to conduct the firm's operations may therefore refrain from mistreating owners to avoid capital exit. However,

110. Uniform Act §§ 502, 401(d) (requiring unanimous owner approval); DEL. CODE ANN. tit. 6, § 18-702 (2016) (requiring unanimous owner approval); N.Y. LTD. LIAB. CO. LAW § 604 (1994) (requiring majority approval of the non-transferring owners); Larry E. Ribstein, *Litigating in LLCs*, 64 BUS. LAW. 739, 741 (2009) (noting many LLC statute terms were designed for closely held firms).

111. Not included is the right to transfer to one's immediate family, an irrevocable trust, an affiliate organization, an existing owner, and the like, which effectively keeps the ownership of the LLC relatively constant.

112. *See, e.g.*, Amended and Restated Limited Liability Company Agreement of PetroAlgae, LLC, § 7.5 (Feb. 16, 2007).

113. *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970) (broadly discussing exit, or the prospect of exit, as a deterrent to abuse by management); Henry Hansmann & Reinier Kraakman, Exit, Voice, and Liability: Legal Dimensions of Organizational Structure (June 2008) (unpublished manuscript) (on file with author).

while this threat of exit imposes constraints on management, it also makes the firm's capital structure fragile—particularly if the firm invests in illiquid assets—or it can perversely provide owners with the power to extract welfare gains from other owners and managers by threatening to take the firm's capital lifeblood with them. Consequently, the default rule for LLCs is that owners have no exit rights. Unless an operating agreement explicitly grants the right, owners can neither withdraw as owners of the LLC nor demand return of their capital contributions or accrued ownership value.[114]

I examined operating agreements to determine when members had the right to withdraw unilaterally and receive the value of their ownership stake.[115] Table 13 collects the results. As expected, withdrawal rights are rare but not nonexistent, occurring in 9% of Delaware LLCs and 6% of New York LLCs. Withdrawal rights were more common among LLCs with more vulnerable minority owners, where the rights would be more valuable. Surprisingly, the withdrawal rights were not confined to those firms with liquid assets or low capital requirements. Firms granting withdrawal rights ranged from low-capital service industries to developing illiquid real estate to operating a car dealership.[116] The withdrawal rights were more likely to appear in LLCs with a vulnerable minority.

114. DEL. CODE ANN. tit. 6, § 18-603 (2015); N.Y. LTD. LIAB. CO. LAW § 606 (1999). Not all commentators agree with the wisdom of this rule, precisely because of the benefits offered by liberal withdrawal rights. *See* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 7, at 180. In fact, until amendments in 1999, New York allowed owners a unilateral withdrawal right upon giving six months' notice.

115. Such a right arises if the operating agreement affirmatively grants the right to withdraw and receive the value of one's ownership interest or if the operating agreement merely grants the right to withdraw, in which case the Delaware and New York LLC statutes provide a default right to receive the value of the withdrawer's ownership stake. DEL. CODE ANN. tit. 6, § 18-604 (1999); N.Y. LTD. LIAB. CO. LAW § 509 (1994). Operating agreements that gave a unilateral right to withdraw but barred paying the accrued ownership value or that gave a right to withdraw contingent on a vote by managers or other owners were not included.

116. Operating Agreement of Launchpad Healthcare Solutions, LLC (Jan. 1, 2012), § 7.1; Operating Agreement of North Park, LLC, § 4.6 (Oct. 26, 2005); Limited Liability Company Agreement of Annapolis Motor Cars, LLC, § 6.2 (Aug. 2002).

Table 13
Unilateral Withdrawal Rights

Delaware (total sample), n = 233	9% *n = 22*
…less vulnerable, n = 158	6% *n = 10*
…more vulnerable, n = 50	18% *n = 9*
New York (total sample), n = 50	6% *n = 3*

4. Tag-Along Rights

Tag-along rights provide that when an owner has negotiated a sale of her ownership stake to an outside party, rights holders can participate in the sale on the same terms.[117] If the purchaser is unwilling or unable to purchase the additional owners' interests, the original negotiating seller's sale stake is reduced so that all owners participate on a pro-rata basis.

Tag-along rights reverse the traditional American business law rule that allows selling owners to capture control premiums when selling shares without sharing these premiums with other owners.[118] The rights protect minority owners by ensuring they are at least partially compensated if a controlling shareholder sells to someone who later harms the firm.[119] Tag-along rights also make inefficient transfers—as well as transfers of control generally—less likely to happen because much of the surplus paid to divest a controlling owner of her stake must be shared with other LLC owners.

The downside of tag-along rights is that they make being a controlling owner less attractive because the rights eliminate one potential method that controlling stakeholders are compensated for their particular burden.[120] Controlling stakeholders bear monitoring and management costs that inure to the benefit of all owners; compensating them for these costs, such as via tag-along rights, provides the inducement needed to gain

117. *E.g.*, John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1799 (2002).

118. *See* Zetlin v. Hanson Holdings, Inc., 397 N.E.2d 387, 389 (N.Y. 1979) (announcing the typical American rule).

119. This could be direct harm, when the new controlling owner expropriates gains from other shareholders, or more indirect harm, as when the new owner is a less effective manager or monitor of managers.

120. It is often argued that tag-along rights also make it less likely that firm-enhancing transfers in control will occur. *E.g.*, George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1066 (1992). However, the holders of these rights are not required to exercise them, so assuming owners are able to coordinate—which is more likely in closely held firms—the rights will not have this additional downside.

controlling owners in the first place.[121] Further, while tag-along rights reduce the likelihood of inefficient transfers of control, they also reduce the likelihood of efficient control transfers, requiring that buyers of control stakes be willing to pay a higher premium to convince the existing controlling owner to leave.[122]

It is worthwhile to note the similarity between the protections and drawbacks of tag-along rights and transfer restrictions, discussed previously. Both methods provide minority owners with protection against opportunistic sales by majority owners. Both also give minority owners the power to hold up efficient ownership transfers. We would expect to see tag-along rights more often in those operating agreements without the direct substitute of transfer restrictions, and Table 14 shows this expectation to be the case. Tag-along rights appear in 27% of the Delaware operating agreements, but they are significantly more common when unaccompanied by transfer restrictions, occurring in 40% of Delaware agreements without transfer restrictions and 22% of agreements with transfer restrictions. The rights were also found significantly less often among LLCs with more vulnerable minority owners and among New York LLCs.

Table 14
Operating Agreements with Tag Along Rights

Delaware (total sample), n = 233	27% *n = 63*
…w/ transfer restrictions, n = 174	22% *n = 39*
…w/o transfer restrictions, n = 59	41% *n = 24*
…less vulnerable, n = 158	32% *n = 51*
…vulnerable, n = 50	12% *n = 6*
New York (total sample), n = 50	10% *n = 5*

121. Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control*: *Ex Ante Control Mechanisms Versus Ex Post Transaction Review*, 169 J. INSTITUTIONAL & THEORETICAL ECON. 160, 162 (2013).

122. Although it might be argued that efficient transfers of control would not be deterred by tag-along rights, since it would be in the minority's interest to facilitate the transfer by not exercising their right, a simple game theory analysis shows that to be unlikely. While it may be in all minority owners' interests to facilitate such a transfer and the ideal situation would have all minority owners committing to refrain from exercising their right, the rational action would be for each individual minority owner to exercise the right so that both efficient and inefficient control transfers are deterred by tag-along rights.

5. Limitation of LLC's Purposes

We now move from direct to indirect ways that operating agreements protect minority owners and align managers' and owners' incentives. The first of these, limiting the LLC's business purpose, restricts the company's ability to surprise minority owners with new projects. Traditional corporate purposes and powers are exceptionally broad, and LLC statutes follow in the same vein. Although LLCs must be organized to accomplish a purpose, this purpose can be simply "any legal act."[123] Broad purposes provide LLCs with flexibility to seize diverse profit-making opportunities they come across. However, wide latitude can allow the LLC to stray from its core competencies, giving rise to greater potential agency costs or opportunism. This scenario can leave owners without recourse when the type of projects they believed they were investing in have changed, especially as there is no owner right to vote on fundamental changes in the LLC's line of business if the LLC purpose is specified broadly.[124]

Alternatively, the LLC can sacrifice some flexibility by specifying a narrower purpose. The narrower the purpose, the more protection that is provided to owners, but the more potential profit-making opportunities are forfeited if they fall outside the LLC's purpose. Although the LLC's purpose can always be broadened by amending the operating agreement, achieving the necessary consensus becomes difficult once the number of owners expands past a handful. As with all the provisions that we have seen so far, therefore, there are both costs and benefits from specifying a broad or narrow business purpose in the LLC operating agreement.

Table 15 shows the prevalence of narrowing the LLC's business purpose.[125] Narrowing occurs in just over half the operating agreements for both Delaware and New York LLCs, but it is far more common among LLCs with less vulnerable owners compared to LLCs with more vulnerable owners.

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123. Uniform Act § 104; DEL. CODE ANN. tit. 6, § 18-106 (2016); N.Y. LTD. LIAB. CO. LAW § 201 (1994).

124. *In re* Seneca Invs. LLC, 970 A.2d 259, 264 (Del. Ch. 2008) (fundamental business change is not prohibited if operating agreement specifies purposes of any lawful act); Rosan v. Chi. Milwaukee Corp., C.A. No. 10526, 1990 WL 13482 (Del. Ch. Feb. 6, 1990).

125. Operating agreements were deemed to narrow the LLC's business purpose if they explicitly restricted the LLC's purpose to pursuing specified activities or else specified the LLC's purpose as a derivate of "any legal act" but conditioned management's decision to pursue new activities on a vote by the owners.

Table 15
Narrowing the LLC's Business Purpose

Delaware (total sample), n = 233	52% *n = 120*
…less vulnerable, n = 158	59% *n = 93*
…more vulnerable, n = 50	34% *n = 17*
New York (total sample), n = 50	58% *n = 29*

6. Required Distributions

Requiring regular distributions constrains managers' opportunism by restricting the pool of money that managers have at their discretion. Without a distribution requirement, managers may self-interestedly accumulate cash even if that cash could be put to better use by owners. This cash hoarding has allowed managers to inefficiently engage in empire building, minimize insolvency risk during an unexpected business downturn, or take other actions that benefit themselves at owners' expense. This problem afflicts all types of organizations, from Apple to nonprofit firms.[126] A distribution requirement acts as a disciplinary device that deters management opportunism by requiring that excess funds be either distributed or else retained only after justification to owners.[127]

Distribution requirements can be draconian disciplinary devices, however. If the requirement is specified as a minimum dollar amount per period, coming up with the cash requires selling illiquid assets at a discount or otherwise could destroy firm value. Weaker distribution requirements that disburse excess cash lose some of the deterrence, as determining what constitutes excess cash necessarily requires some manager discretion and makes it difficult for the firm to finance large projects that require asset accumulation. Consequently, good business reasons may exist for owners who trust managers to dispense with a distribution requirement entirely.

I examined operating agreements for distribution requirements. Delaware's and New York's LLC statutes provide no requirement for firms to make distributions prior to dissolution, leaving it to the parties to affirmatively adopt such a rule if desired.[128] Table

126. Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 35–36 (1990); Tim Worstall, *Apple Puts Carl Icahn's $150 Billion Buyback Proposal to Shareholders*, FORBES (Dec. 28, 2013), http://www.forbes.com/sites/timworstall/2013/12/28/apple-puts-carl-icahns-150-billion-buyback-proposal-to-shareholders/.

127. RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 7, at 209–10.

128. DEL. CODE ANN. tit. 6, § 18-601 (1995); N.Y. LTD. LIAB. CO. LAW § 507 (1994).

16 collects the results of those firms requiring distributions at predetermined intervals.[129] Most, although not all, operating agreements including a distribution requirement adopted a weaker form, requiring a distribution of some derivative of available cash after taking out necessary reserves, rather than mandatory distributions of a minimum amount.[130] As the Table shows, half the Delaware firms required mandatory distributions; the prevalence was lower among New York LLCs.

Table 16
Required Distributions

Delaware (total sample), n = 233	58% *n = 136*
…less vulnerable, n = 158	61% *n = 97*
…more vulnerable, n = 50	50% *n = 25*
New York (total sample), n = 50	42% *n = 21*

7. Limited Life

By default, LLCs have perpetual lifetimes. Absent the firm's insolvency, an affirmative decision by the owners to dissolve the organization, or the entry of an order of judicial dissolution, LLCs continue to exist indefinitely.[131] Perpetual existence provides the firm a stable capital base useful for financing illiquid assets and firm-specific investments. These projects, even if they promise positive expected returns, might not be feasible to undertake if the firm faced imminent deadlines upon which its assets must be liquidated and distributed.

The downside of perpetual existence, however, is that it locks owners' capital into the firm. As we have seen, owners rarely have the right to either transfer or withdraw the value of their ownership stake, so their investment is largely at the mercy of the firm's

129. Those LLCs whose operating agreements required distributions but gave management complete discretion over when, if ever, to make those distributions prior to dissolution were not counted as requiring distributions.

130. *E.g.*, Amended and Restated Limited Liability Company Agreement of Kahuku Holdings, LLC (Apr. 7, 2011), § 4.4 (requiring annual distributions of net cash). This finding mirrors that found by Manesh, *supra* note 36, at 579–80. Most of the operating agreements requiring minimum defined distributions specified that distributions must be at least sufficient to cover owners' imputed tax liability on the LLC's earnings at a predetermined marginal tax rate, although some provided for pre-specified dollar distributions. *E.g.*, Schedule II to Amended and Restated Limited Liability Agreement of Saladworks, LLC (Mar. 9, 2008), § 2.3 (tax distributions); Plan of Conversion and Operating Agreement of Shorenstein Hays-Nederlander Theatres LLC (Nov. 6, 2000), § 6.1 (mandatory $8,333.33 per month distribution per member).

131. Uniform Act § 104(c); DEL. CODE ANN. tit. 6, § 18-801(a)(1) (2016); N.Y. LTD. LIAB. CO. LAW § 701(a)(1) (1999).

management. As with the situations discussed above, this state provides a breeding ground for potential opportunism.

Providing for a limited LLC duration can reduce this potential for opportunism. Once the firm has a finite lifespan, managers are no longer perpetual stewards of the capital pool. Instead, they must periodically go to the well of owners' pocketbooks to raise money for new projects. Since there are few worse signals that a management team could send to future investors than a track record of prior unhappy owners, these forced repeat interactions with the capital markets deter management opportunism.[132]

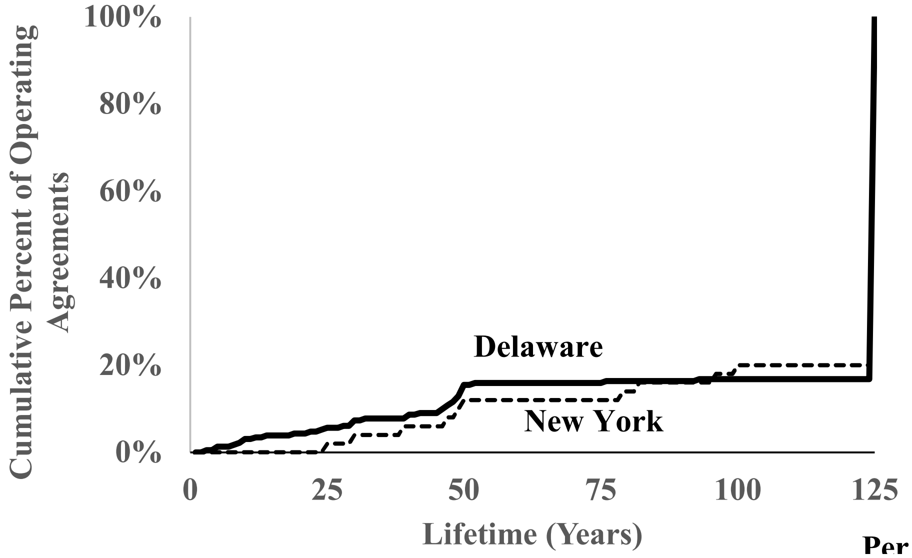
I analyzed operating agreements for limitations on perpetual existence. As Table 17 and Figure 18 show, 17% of Delaware and 20% of New York LLCs had a finite existence, with the limitation most likely to be found among Delaware LLCs with less vulnerable minority owners. No firms limited their existence to the completion of a specific project; instead, all LLCs that chose to restrict their lifetimes did so by specifying a predetermined number of years, ranging from as few as 3 years to as many as 99.

Table 17
Limited Lifetime

Delaware (total sample), n = 233	17% *n = 39*
…less vulnerable, n = 158	22% *n = 35*
…more vulnerable, n = 50	6% *n = 3*
New York (total sample), n = 50	20% *n = 10*

132. *E.g.*, RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 7, at 212.

Figure 18
LLC Term



8. Ownership Stakes Held by Management

The final technique of aligning owners' and managers' interests I examined was to determine the percentage of ownership shares that were held by the firm's managers. Although in theory managers run the firm to maximize the welfare of its owners,[133] the agency cost examples discussed throughout this Article have shown this is rarely the case. When managers are not the sole residual claimants, they gain the entire benefit that decreased profitability through increasing manager perquisites provides, while sharing with others the cost of decreased profitability. The larger a stake that managers have in the firm's success, the greater share of the costs they bear and the less likely it is that managers will put their personal interests over the firm's.

Of course, it is not always feasible to pay managers of the firm with a sizable ownership stake. Managers may not be keen on taking the undiversified position that a sizable ownership position brings.[134] Moreover, firms often find that the readiest and cheapest access to capital comes from combining several different owners who may not

133. HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 20–22 (1996); Peter Molk, *The Puzzling Lack of Cooperatives*, 88 TUL. L. REV. 899, 905–10 (2014); Peter Molk, *The Ownership of Health Insurers*, 2016 U. ILL. L. REV. 873, 887 (examining how the identity of a firm's owners affects operations in the specific context of health insurance).

134. The lack of diversification from having both the manager's job and investment tied to the success of the same firm implies an increase in the compensation necessary to attract managers or inefficient attempts by management to reduce the firm's riskiness. *See* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 7, at 209 (discussing this problem).

be qualified for or have no desire to manage the firm. As the percent of equity held by these non-managing owners grows, the percent of profits paid to managers decreases. At the extreme case, in large publicly traded firms, managers have diminishingly small ownership stakes, routinely under a fraction of 1%.[135] The 1% stake of diminished profitability would hardly deter these managers from capturing perquisites.

Publicly traded corporations nevertheless succeed with a diffuse and diversified ownership base because of the increased scrutiny that analysts and the financial limelight bring to these firms' management. The exchanges on which these firms' stock is traded also impose various owner protections.[136] Finally, since most publicly traded firms are corporations, they come with the mandatory rules of corporate law that are aimed at protecting owners. Privately held LLCs might feature none of these protections. Even large privately held firms may not be regular fixtures of the financial press; because these firms are not subject to SEC disclosure requirements, it is harder to figure out what managers are doing and, therefore, for the news media to hold them accountable.[137] Furthermore, these firms do not trade on public exchanges and so need not comply with those exchanges' owner protection rules. Finally, as LLCs, these firms are allowed to—and, as we have seen, often do—waive the mandatory owner protections of corporate law. We might therefore expect LLC managers to hold comparatively large ownership stakes to deter the management opportunism that might otherwise result.

I analyzed the operating agreements and other available documents to determine the size of ownership stakes held by management. Interests were attributed to managers if the manager was an individual and held an ownership stake, if the manager was a firm but that same firm held an ownership stake, or if the manager was an individual and that individual, although holding no ownership stake in her individual capacity, signed the operating agreement on behalf of a firm holding an ownership stake (for instance, if an individual formed a separate firm within which to own a stake of the LLC). With this method, the ownership percentage could be calculated for 91% of the LLCs. Figure 19 presents the results. As can be seen, most LLCs had management holding sizable ownership stakes. Two–thirds of Delaware LLCs and one-half of New York LLCs had management holding at least two-thirds of the ownership interests ownership stakes; 45% of Delaware LLCs and 35% of New York LLCs had managers cumulatively owning the entire LLC.[138] Only three LLCs had management with no ownership interest.

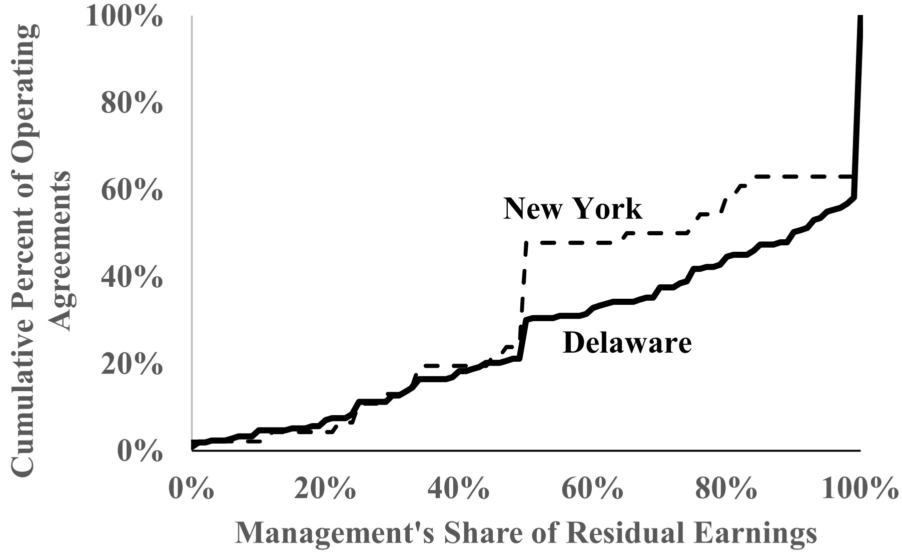
135. Although management of publicly traded corporations are often compensated with some form of incentive based compensation, this compensation generally insulates management from downside risk so that agency costs are deterred only if the firm would otherwise have made a profit. *See id.* at 218.

136. *See supra* note 45 and accompanying text (noting the NYSE requires companies to comply with investor safeguards).

137. Moreover, because these firms are privately held, their number of owners is necessarily restricted so that financial investigation of these firms would not interest the general investing public in the same way that stories about a widely held company would. 15 U.S.C. § 78*l*(g)(1) (2015) (requiring registration for firms with 2000 equity shareholders of record or 500 non-accredited investors).

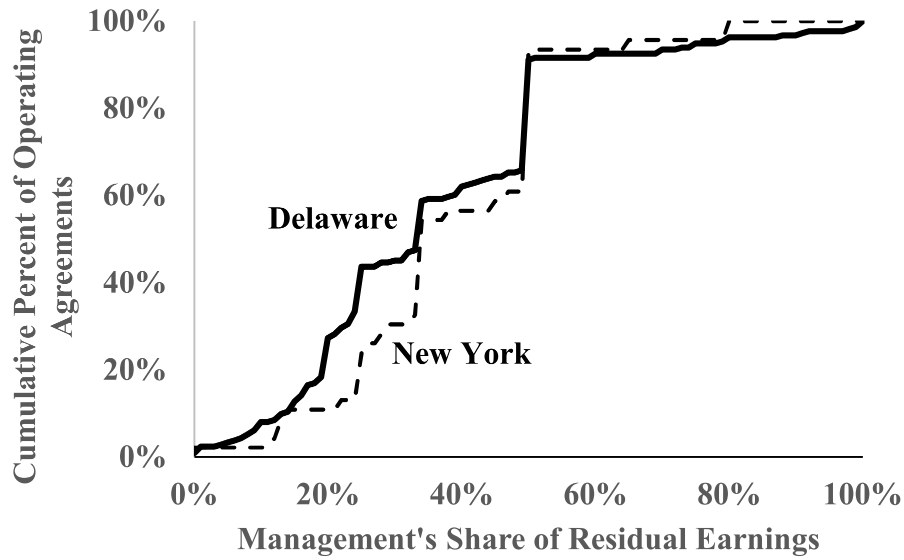
138. Note that, because of sampling issues, the cumulative percentages may be somewhat inflated. Management's ownership share could not be calculated for 18 of the 219 LLCs, but it was obtainable for every one of the LLCs that had 100% management ownership, so the sample was biased toward higher total ownership numbers.

Figure 19
Total Ownership Stake Held by Management



Of course, while the collective size of the ownership stake held by management is important, the stake held by each manager also influences the incentive to engage in self-interested behavior. A single manager owning 90% of the firm would be expected to have lower agency costs than nine managers who each own 10% stake, even if the aggregate 90% stake is the same. To capture this component, Figure 20 presents the average ownership share per manager. When considered on a per-manager basis, the holdings are markedly lower. Half of the Delaware LLCs have management with less than 33% ownership stake per manager; under 10% have management owning more than 50% per manager. New York LLCs followed a similar distribution.

Figure 20
Average Ownership Stake Held Per Manager



C. Summary

We can see that LLCs routinely take advantage of LLC statutes' flexibility to adopt and waive protections that are mandatory for other business organizations. Moreover, on a sample-wide comparison, the two types of Delaware LLCs, as well as the Delaware and New York LLCs, adopt roughly similar protections, as summarized in Table 21. While the samples from the two states show different patterns for particular terms, the overall picture is one of substantial modification to traditional corporate protections and suggests that Delaware-formed LLCs are not outliers in their tendency to modify default operating agreement provisions.

Table 21
Modification by Firm Type

Modification	DE (Total Sample)	Delaware vs. New York (Total Samples)
Authorizing Competition	40%	No statistical difference
Business Opp. Waiver	40%	No statistical difference
Duty of Loyalty Modification	64%[b]	No statistical difference
Duty of Good Faith Modification	18%	No statistical difference
Duty of Care Modification	45%	No statistical difference
Drag-Along Rights	24%[c]	Delaware significantly higher***
Judicial Diss. Waived	12%	No statistical difference
Average Share to Amend	85%	New York significantly higher**
Transfer Restriction	75%	New York significantly higher**
Withdrawal Right	9%[y]	No statistical difference
Tag-Along Right	27%[c]	Delaware significantly higher***
Limited LLC Purpose	52%[c]	No statistical difference
Required Distributions	58%	Delaware significantly higher**
Defined Lifetime	17%[c]	No statistical difference
Avg. Management Stake	74%	No statistical difference
Avg. Stake Per Manager	36%	No statistical difference

[a] signifies more vulnerable lower, p-value less than 0.10; [b] 0.05; [c] 0.01.
[x] signifies more vulnerable higher, p-values less than 0.10; [y] 0.05; [z] 0.01.
* signifies p-value less than 0.10; ** 0.05; *** 0.01.

The descriptive results, while useful in understanding LLCs' propensity to waive traditional owner protections, do not answer whether this behavior is occurring in socially efficient ways. If, for example, LLCs' contractual flexibility to weaken protections for less sophisticated minority owners without adopting countervailing measures, LLC statutes' flexibility could be highly troubling. Part VI takes up this issue.

VI. WHAT MOTIVATES CONTRACTING AROUND DEFAULTS?

Part V revealed that LLC operating agreements weaken owner protections in a variety of ways, but they also adopt assorted substitute owner protections. One specific prediction from the contractarian approach is that among sophisticated parties with relatively equal bargaining power, reducing and adding protections would have an inverse relationship: the more standard protections that are cut back, the more additional protections owners would demand to mitigate the risk of opportunism by managers or other owners.

On the other hand, if minority owners lack bargaining power or sophistication, we might expect little relationship between cutting back and adding to owner protections, at least for those organizations with these weak minority owners. In a worst case scenario, we might even see a positive relationship: firms with comparatively more elimination of standard protections may also have comparatively fewer substitute safeguards in an attempt to maximize the potential for later opportunism by managers or majority owners.

Finally, operating agreements might reflect minimal strategic drafting of any sort. Instead, operating agreements might reflect an effectively random assignment of protections and waivers. For example, perhaps operating agreements are determined by whatever form the drafting attorneys habitually use, with little or no negotiation among the owners and managers for specific protections.[139] In that case, we would expect to see no relationship between waivers and additional protections on a sample-wide basis with no meaningful difference for the sophisticated and vulnerable minority subsamples.

I used the Delaware operating agreement data to determine both the existence of any relationship between reducing and strengthening owner protections as well as whether this relationship varies with the presence of vulnerable minority owners. The next two Sections analyze this issue.

A. Testing for Efficiency

I started by constructing an owner protection index to capture the strength of affirmatively adopted owner protections in the operating agreements. Although many owner protections apply by default to LLCs, five particular protections do not apply by default but were affirmatively adopted at a meaningful rate. These were the right to withdraw one's ownership stake from the LLC, a business purpose restriction, required distributions, a limited lifetime, and transfer restrictions through either tag-along rights or requirement that minority owners consent to a transfer. Formally, the index equals the sum of the following:

139. Miller, *supra* note 29, at 321–23.

$$Index = Withdrawal + Purpose\ Limitation + Req'd\ Dist + Finite\ Life + Max(Trans, Tag)$$

Higher values of the index correspond to operating agreements that adopted more minority owner protections.

I then ran Poisson regressions to determine the relationship between waiving or reducing default owner protections and affirmatively adding owner protections. With the owner protection index as the dependent variable, I included as explanatory variables the indicator variables for affirmative weakening default owner protections (authorizing competition, waiving the corporate opportunity doctrine, modifying fiduciary duties, drag-along rights, and waiving the right to seek judicial dissolution), the number of members, the total ownership stake held by management, the ownership share per manager, and the presence of vulnerable minority owners as dependent variables. The model was estimated separately for the entire pooled sample and for the subsets that did and did not have vulnerable minority shareholders.

Table 22 contains the results. As the Table shows, when looking at the pooled sample, most of the explanatory variables are not significantly associated with any meaningful impact on those owner protections constituting the index. Several of the explanatory variables even have impacts in an unexpected direction. When looking at the aggregate sample, therefore, there is very little evidence that supports the efficiency bargaining envisioned by LLC contractarian enthusiasts.

Table 22: Relationship Between Protections and Waivers

	Pooled Sample			Less Vulnerable Only		More Vulnerable Only	
Competition Allowed	-0.115*	-0.181***	-0.132	-0.128	-0.187***	-2.069***	-2.471***
	(0.07)	(0.07)	(0.10)	(0.10)	(0.06)	(0.34)	(0.52)
Business Opportunity Doctrine Waived	0.073	0.120	0.054	0.070	0.114	2.914***	3.262***
	(0.05)	(0.08)	(0.13)	(0.11)	(0.09)	(0.62)	(0.56)
Duty of Loyalty Waived/Exculpated/Indemnified	0.168***	0.185***	0.087	0.035	0.024	-0.734***	-0.911***
	(0.06)	(0.05)	(0.07)	(0.07)	(0.07)	(0.23)	(0.23)
Duty of Good Faith Waived/Exculpated/Indemnified	0.009	0.010	-0.026	-0.109	-0.132	-1.085**	-1.072***
	(0.10)	(0.12)	(0.12)	(0.08)	(0.09)	(0.48)	(0.24)
Duty of Care Waived/Exculpated/Indemnified	-0.166*	-0.164	-0.088	-0.092	-0.071	0.456***	0.577*
	(0.09)	(0.10)	(0.09)	(0.10)	(0.09)	(0.18)	(0.32)
Drag Along Right Included	0.219*	0.229*	0.176	0.186*	0.196*	1.526***	1.459***
	(0.12)	(0.12)	(0.11)	(0.10)	(0.10)	(0.34)	(0.34)
Members Waive Right to Seek Judicial Dissolution	0.167**	0.116	0.085	0.164*	0.091	-0.445**	-0.768***
	(0.07)	(0.07)	(0.09)	(0.09)	(0.06)	(0.22)	(0.28)
Ownership Share Required to Amend Operating Agreement	0.355**	0.352**	0.380***	0.232	0.144	2.310***	2.856***
	(0.14)	(0.17)	(0.14)	(0.17)	(0.15)	(0.51)	(0.96)
Number of Members (Log)	-0.052	-0.074*	-0.069*	-0.071	-0.097**	-0.207***	-0.313***
	(0.03)	(0.04)	(0.04)	(0.05)	(0.05)	(0.06)	(0.08)
Ownership Share Held by Management		0.166	0.130		0.223*		0.004
		(0.13)	(0.09)		(0.12)		(0.46)
Ownership Share Per Manager		-0.056	0.061		0.073		0.163
		(0.11)	(0.15)		(0.14)		(0.92)
More Vulnerable Members			-0.322***				
			(0.09)				
Constant	0.883***	0.803***	0.546**	1.429***	1.322***	-5.351***	-5.599***
	(0.22)	(0.28)	(0.26)	(0.17)	(0.27)	(1.17)	(0.80)
N	231	211	194	158	145	50	49

* signifies p-value less than 0.10; ** 0.05; *** 0.01. Estimated coefficients measure the impact on log-counts. All regressions include year and industry fixed effects. Robust standard errors in parentheses and are clustered at the NAICS industry code level to correct for autocorrelation by industry.

Little changes when we consider the subsamples with vulnerable minority owners and with exclusively less vulnerable owners. Again, many of the estimates are either insignificant, or significant in the opposite direction expected by the efficiency bargaining theory. Moreover, the most statistically significant findings emerge with the subsample of LLCs with more vulnerable owners, rather than the portion with exclusively less vulnerable, more sophisticated members. This result is particularly surprising because the bargaining theory predicts the strongest relationships to emerge when examining LLCs with less vulnerable, more sophisticated owners, as sophisticated owners are the ones more likely to extract protections through aggressive bargaining and representation.[140] The almost complete lack of that evidence in the subsample of less vulnerable, sophisticated owners suggests that seeking more efficient arrangements is not the primary motivating factor behind drafting operating agreement terms. Instead, the apparent randomness of LLC terms indicates that in large part, the initial forms supplied by lawyers rather than bargaining for efficient protections could be what explains the protections included in operating agreements.[141]

However, returning to the aggregate sample, Table 22 shows that LLCs with more vulnerable owners affirmatively adopt significantly fewer owner protections than those LLCs with less vulnerable owners, irrespective of whether other traditional corporate protections are modified. Indeed, this result is one of the strongest statistical findings from the study. In one sense, this result may not be surprising. When minority owners have less money at stake and are therefore less likely to be represented by sophisticated legal counsel or be able to represent themselves, we would expect that they would extract weaker legal protections. But the data show little evidence of the bargaining for efficient terms envisioned by contractual freedom enthusiasts. It appears that less vulnerable, more sophisticated LLC minorities bargain for relatively more protection, but the additional protection they seek does not vary systematically by the aggressiveness of waiving or modifying traditional corporate protections. In this way, there is evidence of limited bargaining among the parties to LLC operating agreements, but not in the way envisioned by contractarians.

While there is limited evidence of bargaining, combining Tables 21 and 22 shows worrisome results for more vulnerable LLC owners. Vulnerable parties give up most traditional protections at the same rate as less vulnerable parties, but they extract significantly lower affirmative protection. While it is true that LLCs with less vulnerable owners more often include minority-unfriendly duty of loyalty modifications and drag-along rights, this factor is not a compelling explanation for their adoption of significantly more minority protections, as neither term corresponds on its own to an increase in protections for any of the samples.

Vulnerable minority owners are already more likely to suffer opportunism even if they have the same legal rights as other owners. Their small ownership stake implies less attention to the LLC's affairs and more leeway for unnoticed opportunism by managers and majority owners.[142] The results show that LLCs exacerbate vulnerable minority owners' position by adopting weaker legal protections for them, widening the space for potential opportunism. Although operating agreements cannot show whether LLCs actually take advantage of vulnerable owners' position, the groundwork for this opportunism has been laid.

140. *See e.g.*, RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 7, at 194–222 (describing the traditional corporate protections and substitute safeguards over which LLC owners would bargain).

141. For an example of this argument, see Miller, *supra* note 29.

142. *E.g.*, EASTERBROOK & FISCHEL, *supra* note 23, at 25, 231 (noting the similar plight of minority owners in publicly traded corporations).

B. Other Explanations

In addition to the interpretation discussed above, complementary or competing explanations could also be consistent with the findings. Foremost among them is the possibility of omitted variables, in which case the included variables could paint a misleading picture. Although I coded the important terms that appeared with any degree of frequency, some terms defy coding and by necessity could not be included, which is a necessary limitation of the study. However, the fact that all key contractual terms identified by LLC contractarians (plus additional terms) were included in the study without finding strong evidence of efficiency bargaining suggests that, in practice, LLCs are failing to attain the ideal heights envisioned by default rule supporters.

Nevertheless, it is worthwhile to consider how omitted variables might factor into the pictures. Non-contractual dynamics can provide significant owner protections yet would not appear in the LLC operating agreement. Consider, for instance, the value of reputation. Regardless of contractual terms, managers may wish to cultivate a reputation for success and fair dealing that could facilitate their moving to higher prestige and higher paying positions.[143] For example, several LLCs in my sample featured repeat relationships among owners who had successfully backed the same manager repeatedly over time. Owners may benefit from developing a reputation for honesty that could reduce their cost of raising capital for future projects. When developing a good reputation is costly, managers and majority owners may refrain from opportunism even when they are contractually permitted to do so. Owners may consequently buy into LLCs headed by owners and managers with good reputations regardless of terms in the operating agreement. In that case, because this value of reputation cannot be captured in the regression models, the estimates would be skewed towards insignificance, with the degree of skew depending on the proportion of the sample for which reputation is important. Note this explanation implies that weakening and strengthening owner protections has a less meaningful inverse relationship only for those LLCs where reputation is a key substitute protection; for those LLCs lacking a good reputation protection mechanism, contractual terms would maintain their importance.

Similarly, social relationships could provide a deterrent against opportunism. Owners who all belong to the same family, for example, might confidently assume that the manager will be unlikely to expropriate earnings at their expense when she must sit next to them at the annual Thanksgiving dinner.[144] And the manager of a local LLC might be less inclined to expropriate gains from owners belonging to the same community—unlike the faceless owners of more widely dispersed ownership, it can be far more difficult to profit at another's expense when you know who that other is.[145] When social norms depress opportunistic tendencies, parties may be willing to join an operating agreement even if contractual terms provide little minority owner protection.

Again, as with the value of reputation, the impact of social norms is not captured in my models and would dampen the significance of the model's estimates. Just as with

143. For recent work on the interaction between reputation and corporate behavior, see generally Roy Shapira, *A Reputational Theory of Corporate Law*, 26 STAN. L. & POL'Y REV. 1 (2015).

144. For evidence of some of the power of social norms, see ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 123–264 (Harvard University Press 1994).

145. *Id.*; Amitai Aviram, *A Paradox of Spontaneous Formation: The Evolution of Private Legal Systems*, 22 YALE L. & POL'Y REV. 1, 63–67 (2004) (discussing the frameworks necessary for norm enforcement).

reputation, however, the impact of social norms implies only that the weakening/strengthening tradeoff matters less for some LLCs, not that it is nonexistent.

Finally, I reiterate that this model tests only one prediction from the contractarian economic efficiency model: that as traditional protections are cut back or eliminated, parties will bargain for more optimal substitute contractual safeguards. It could be that some terms are so objectionable to all parties, even minority owners, that reducing or eliminating them makes all parties better off even without adopting substitute protections. Because the test in this Part assumes that parties bargain for substitute contractual safeguards, it will underestimate the degree of efficiency bargaining to the extent of this situation. Moreover, efficiency bargaining need not occur exclusively along the dimension of contractual terms. Some parties could instead bargain for a mixture of contractual protections *and price*. For example, minority owners might respond to reductions in contractual protections not by seeking additional contractual protection elsewhere, but instead by reducing the price they will pay for their ownership interest. Testing this response would require comparing the prices that owners paid for interests in similar LLCs with varying contractual provisions. Because data limitations make such a comparison impossible, it again means the test in this Part may underestimate the degree of efficiency bargaining that occurs.

Unless these alternative explanations disproportionately affect LLCs with more vulnerable minority owners, the troubling finding persists that as a whole, LLCs with vulnerable minority owners adopt fewer contractual safeguards. While this does not conclusively mean that no efficiency bargaining takes place, the results suggest a stronger need to ensure less sophisticated owners are adequately protected when default rules prove insufficient. I take up this issue next.

C. Protecting Vulnerable Owners

The results suggest that modifying default LLC owner protections may more often be done with an eye to potential opportunism rather than for efficiency reasons. If relatively few LLCs are engaging in nuanced bargaining in pursuit of efficiency, then the costs of importing mandatory owner protections to LLCs decrease, and the benefits from protecting parties who apparently do not protect themselves increase, making a stronger case for proposals that restrict contractual freedom. Layered on top of this is the finding that LLCs with vulnerable minority owners—already most at risk for manager and majority owner opportunism—adopt fewer owner safeguards, again buttressing the case for increasing owner protections. On the other hand, undoubtedly some sophisticated parties are bargaining for efficient operating agreements, and the only way this bargain can be accomplished is through a system of default, but not mandatory, protections.

There is thus a tension between protecting more vulnerable owners and allowing sophisticated parties the contractual space to achieve efficient governance agreements. Unfortunately, therefore, there is no clear answer for how owner protections should be increased without unduly burdening sophisticated owners. While some experts have recommended imposing mandatory owner protections akin to those found for corporations,[146] this Article raises caution against such a significant step. Sophisticated parties are modifying all traditional corporate protections that are merely defaults for

146. *See, e.g.*, *supra* notes 8–9 (discussing LLCs' contractual freedom).

LLCs. Switching default protections to mandatory ones could not only have significant disruptive effects for these already-extant LLCs, but also impact the terms contained in new operating agreements in unexpected ways—perhaps by promoting additional undermining of other non-mandatory protections or suppressing the affirmative adoption of owner protections, any of which would reduce the potential efficiency of LLC governance.[147] The extent of efficiency loss from imposing mandatory rules ultimately depends on how many LLCs actually bargain to modify those terms in their operating agreement. The above analysis suggests that comparatively few LLCs may actually do so; instead, the particular terms included in operating agreements may be better explained by the terms their lawyers happen to use in their form operating agreement documents or for some other reason. Nevertheless, telling those comparatively few LLCs that *do* carefully bargain for governance terms that they cannot operate as intended undoubtedly increases their cost of doing business.

Requiring mandatory owner protections for LLCs is of course not the only way to protect minority owners. Relying on judicial oversight to prevent actual cases of opportunism, which may be the current trend in Delaware,[148] has the benefit of permitting contractual freedom while deterring undesirable behavior when it actually occurs, rather than the overinclusive solution that seeks to prevent the necessary, but not sufficient, conditions for expropriation created by waivers and modifications. This approach too has its drawbacks, namely that the judiciary may provide an imperfect screen for behavior that constitutes expropriation. Above all, it is apparent that there is no easy way to uphold contractual freedom while protecting vulnerable owners.

VII. CONCLUSION

This Article has shown the ways that LLCs use LLC statutes' contracting flexibility to allocate rights in ways impossible to replicate with other organizational forms. LLCs regularly jettison rights that are mandatory for other business entities and employ a number of alternative measures that align manager and owner interests. However, for both LLCs as a whole and for LLCs with less vulnerable, more sophisticated owners, there is little relation between detracting from and adding to owner protections, implying a lack of systematic bargaining for efficient contractual terms. On the contrary, I find significantly fewer owner protections for those LLCs with weaker, more vulnerable minority owners, which suggests that when LLCs modify default owner protections, it may on average be more with an eye to potential undesirable opportunism, rather than in pursuit of economic efficiency.

147. *See* Verity Winship, *Shareholder Litigation by Contract*, 96 B.U. L. REV. 485, 528 (2016) (discussing recent corporate efforts to limit shareholder litigation rights through terms in corporate charters and bylaws).

148. *See* Mohsen Manesh, *Equity in LLC Law?*, 44 FLA. ST. U. L. REV. (forthcoming 2017) (discussing courts' willingness to override LLC contractual terms in the name of equity).