

## Fairness and Good Faith as a Precept in the Law of Corporations and Other Business Organizations

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In my first class, teaching Business Organizations at Notre Dame, I had an unsettling experience. This was at a time when opposition to the Vietnam War was running high, and many students were radicalized. Just as I began to offer a perspective on the course, a student raised his hand and essentially announced: “I am opposed to this class and do not like being here.”

As a young professor, this was not exactly how I thought my teaching experience would begin. As I tried to recover my aplomb, I asked why, and he replied that he was a communist. I responded that, if that were the case, he must be a person who was concerned about people and values; he replied affirmatively. This gave me my opening, and I responded: “Business Organizations is about values—ethical values and economic values—so you should appreciate this course.”

Let us explore the foregoing premise. Matters like fairness, good faith, loyalty, conflicts of interest, and other fiduciary duty concerns implicate ethical values. But persons who engage in unethical behavior generally do not do so for the fun of it. Their motivations generally involve money or power and, thus, a course in Business Organizations also deals with economics, broadly defined as what people are seeking to accomplish, why they are so motivated, and what procedures they employ.

The law is not just a set of rules. Unless the rules are in basic accord with the community’s sense of values, they will not be respected. People instinctually believe that the law, in general, should be fair. Should the same not be true for the law affecting business organizations? For some reason, the answer to this question may not be as obvious. Consider another student vignette. One day, my wife arrived at the law school to meet me for lunch after class. As the students were filing out of the classroom, she heard one student remark: “Can you believe that guy? What’s all this stuff about fairness? I want

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to learn corporate law, not this mushy stuff.” Fortunately, most students—and most judges—do not consider fairness and fiduciary duties to be mushy stuff.

The thrust of this Article will focus on only one aspect of fiduciary duty: the fiduciary duty of good faith and fairness that majority shareholders owe to minority shareholders. Actually, the foregoing sentence needs to be rephrased since it is too restrictive in two ways: (1) one does not need a majority of shares to have control of a corporation; and (2) fairness issues arise not only for shareholders of corporations, but in partnerships and limited liability companies (“LLCs”) as well. Thus, we need to speak of the fiduciary duty which controlling members<sup>1</sup> of an entity owe to the controlled member.

As the law goes, the development of a fiduciary duty owed by one member to another in a corporation or an LLC is of comparatively recent vintage, as contrasted with partnerships where partners have always owed fiduciary duties to each other.<sup>2</sup> Corporate law has always recognized the fiduciary duties that a director owes to the entity, the most well known of which are the duties of care and loyalty.<sup>3</sup> But early courts took a majoritarian approach to responsibilities at the shareholder level.<sup>4</sup> Corporation statutes generally embody majoritarian procedures: a majority of shares constitutes a quorum and a majority of a quorum constitutes shareholder action.<sup>5</sup> In essence, according to some courts, minority shareholders have contracted for majoritarian power within the corporation and should not complain when it is exercised.

Professor O’Neal criticized the myopic, majoritarian approach that some courts had taken:

In the past, some courts permitted majority shareholders to exercise, without restriction other than the avoiding of fraud, whatever powers they had as controlling shareholders under the statutes and the corporation’s charter and bylaws; further, they treated the fiduciary duties of the directors as running only in favor of the corporation, not

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1. “Member” here means a shareholder in a corporation, a member in an LLC, and a partner in a partnership. It could also include a beneficiary in a business trust.

2. *See, e. g.*, *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928) (recognizing that joint ventures are subject to fiduciary duties akin to those of partnerships).

3. *See* 7, 8 CHARLES W. MURDOCK, ILLINOIS PRACTICE—BUSINESS ORGANIZATIONS, [ §§ ] 13–14 (1996) (discussing generally the duties of care and of loyalty).

4. *See Wheeler v. Pullman Iron & Steel Co.*, 32 N.E. 420, 423 (Ill. 1912) (explaining the fundamental principle in the law of corporations that the majority sets corporate policy).

5. *See* 805 ILL. COMP. STAT. 5/7.60 (2002) (outlining the requirements for a quorum of shareholders and noting that the articles of incorporation may require any number or percent greater than a majority of votes up to and including a requirement of unanimity to constitute a quorum).

the minority shareholders. The view that the controlling shareholders and the directors do not owe fiduciary duties to minority shareholders is outmoded, at least as applied to attempts to eliminate minority shareholders from the enterprise or to deprive them of their proportionate powers and rights without a just equivalent. Where several owners carry on an enterprise together (as they usually do in a close corporation), their relationship should be considered a fiduciary one similar to the relationship among partners.<sup>6</sup>

While there were intimations that controlling shareholders had a fiduciary duty to minority shareholders before *Jones v. H.F. Ahmanson & Co.*, this case, in an opinion written by Justice Traynor, an extraordinary jurist, is arguably the first “pure” shareholder fiduciary duty case.<sup>7</sup> The controlling shareholders in the operating company transferred their shares to a holding company and took the holding company public.<sup>8</sup> From their perspective, all they did was transfer their shares, an action to which they were entitled and which was wholly consistent with a fundamental characteristic of the corporate form: the free transferability of shares.<sup>9</sup> Nevertheless, the court held that the majority had used their control power in the operating company to create, in an indirect manner, a market for their shares in the operating company to the exclusion of the minority shareholders, and thus had breached their fiduciary duty to minority shareholders.<sup>10</sup>

Shortly after *Ahmanson*, the Massachusetts Supreme Judicial Court decided two cases that have been the bedrock upon which the fiduciary duty of shareholders in closely held corporations has developed. In *Donahue v. Rodd Electrolyte Co.*, the court recognized that “the close corporation bears striking resemblance to a partnership.”<sup>11</sup> Commentators and courts have noted that the close corporation is often little more than an “incorporated” or “chartered partnership.”<sup>12</sup> The court further opined that “[j]ust as in a partnership, the relationship among the stockholders must be one of trust, confidence and absolute loyalty if the enterprise is to succeed.”<sup>13</sup> Consequently, the court held that:

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6. F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S CLOSE CORPORATIONS § 9:19 (3d ed. 1986) (footnotes omitted).

7. *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969).

8. *Id.* at 467.

9. *Id.* at 471; see 805 ILCS 5/6.55 (by implication shares are freely transferable unless restricted by contract per the statute).

10. *Ahmanson*, 540 P2d at 476.

11. *Donahue v. Rodd Electrolyte Co.*, 328 N.E.2d 505, 512 (Mass. 1975).

12. *Id.*

13. *Id.*

[S]tockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined the standard of duty owed by partners to one another as the ‘utmost good faith and loyalty.’ Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.<sup>14</sup>

In short, shareholders must deal with each other fairly.

*Donahue* dealt with a case in which siblings bought out their father but declined to buy out the minority shareholder.<sup>15</sup> The court determined that, in essence, the siblings made a market for Dad’s shares, but not for the minority’s shares.<sup>16</sup> In so doing, Dad was given access to corporate assets, but the minority shareholder was not.<sup>17</sup> Thus, the plaintiff was denied the “equal opportunity” to access corporate funds and sell her shares.<sup>18</sup> Using a constitutional law analogy, plaintiff was denied equal protection.

The second Massachusetts case, *Wilkes v. Springside Nursing Home*, also used, in effect, a constitutional law analogy: the “least restrictive” alternative.<sup>19</sup> In *Wilkes*, the plaintiff, who was one of four original investors, induced two of the other three investors to authorize the sale of some corporate property to Quinn, the fourth investor, at a higher price than Quinn wanted to pay. This led to a deterioration in the relations between plaintiff Wilkes and Quinn, and two years later, Wilkes was not reelected as either an officer or a director and lost his salary.

The *Wilkes* court reiterated that shareholders in a close corporation owe a duty to each other, akin to that which partners owe to each other.<sup>20</sup> In reviewing earlier cases, the court characterized the deprivation of employment of minority shareholders as freeze out techniques which “[have] been successful because courts fairly consistently have been disinclined to interfere in those facets of internal

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14. *Id.* at 515.

15. *Id.* at 508.

16. *Id.* at 520.

17. *Id.*

18. *Id.*

19. *See generally* *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 657-63 (Mass. 1976) (stating that courts, when called on to settle shareholder disputes, must weigh the majority shareholders’ legitimate business purpose against the practicality of a less harmful alternative).

20. *Id.* at 661. The duty is one of “utmost good faith and loyalty.” *Id.* (quoting *Cardullo v. London*, 105 N.E.2d 843 (Mass. 1952)).

corporate operations, such as the selection and retention or dismissal of officers, directors and employees, which essentially involve management decisions subject to the principle of majority control.”<sup>21</sup> The court quoted Professor O’Neal: “[t]he minority stockholder typically depends on his salary as the principal return on his investment, since the ‘earnings of a close corporation . . . are distributed in major part in salaries, bonuses and retirement benefits.’”<sup>22</sup>

However, the *Wilkes* court recognized that “the controlling group in a close corporation must have some room to maneuver in establishing the business policy of the corporation.”<sup>23</sup> Thus, the majority can take action such as dismissing directors or firing officers if there is a “legitimate business purpose” for such action.<sup>24</sup> Nevertheless, even if there is a legitimate business purpose, “it is open to minority stockholders to demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority’s interest.”<sup>25</sup>

For example, if Wilkes were the treasurer but proved incompetent at accounting, the majority shareholders would have a legitimate business purpose in removing him as treasurer. However, if Wilkes were mechanically inclined, he could demonstrate that he could fill the role of facilities manager. With respect to compensation, he would be entitled to the same compensation as before if other shareholders received equal compensation, irrespective of the role in which they functioned. This was the pattern in *Wilkes*. If, on the other hand, shareholders were compensated at the market value of the role they fulfilled, then Wilkes would be entitled to the compensation appropriate for a facilities manager, rather than that of a treasurer.

In *Wilkes*, the majority could not show a legitimate business purpose in discharging Wilkes. Accordingly, he was entitled to compensation during the period he was terminated. The court concluded:

At a minimum, the duty of utmost good faith and loyalty would demand that the majority consider that their action was in disregard of a long-standing policy of the stockholders that each would be a director of the corporation and that employment with the corporation would go hand in hand with stock ownership; that Wilkes was one of the four originators of the nursing home venture; and that Wilkes, like the others, had invested his capital and time for more than fifteen

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21. *Id.* at 662.

22. *Id.* (quoting F.H. O’NEAL, CLOSE CORPORATIONS § 1.07 (1971)).

23. *Id.* at 663.

24. *Id.*

25. *Id.*

years with the expectation that he would continue to participate in corporate decisions. Most important is the plain fact that the cutting off of Wilkes's salary, together with the fact that the corporation never declared a dividend . . . assured that Wilkes would receive no return at all from the corporation.<sup>26</sup>

The *Donahue* and *Wilkes* cases have been cited in at least forty-two jurisdictions<sup>27</sup> and now represent the prevailing jurisprudence with

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26. *Id.* at 664.

27. Shepardizing these cases reveals they have been cited in at least thirty-five state appellate court decisions and in seven federal circuit cases. *See, e.g.*, *Combs v. Pricewaterhousecoopers LLP*, 382 F.3d 1196, 1202 (10th Cir. 2004) (recognizing Colorado law of heightened fiduciary duties among majority/minority shareholders in a close corporation); *Med. Air Tech. Corp. v. Marwan Inv., Inc.*, 303 F.3d 11, 20 (1st Cir. 2002) (stating that under Massachusetts law, shareholders in a close corporation owe a fiduciary duty of utmost good faith and loyalty which is a higher standard than a simple good faith and inherent fairness standard); *Hollis v. Hill*, 232 F.3d 460, 469 (5th Cir. 2000) (holding that under Nevada law, vice-president demonstrated injury as a shareholder as a result of president's actions in freezing him out of the corporation); *Nagy v. Riblet Prod. Corp.*, 79 F.3d 572, 576 (7th Cir. 1996) (certifying to Supreme Court of Delaware question of whether majority shareholders owed duty of loyalty to former CEO, who was also minority shareholder); *Everett v. I-Net, Inc.*, 900 F.2d 251, 251 (4th Cir. 1990) (citing *Wilkes* in a case involving shareholder oppression); *Clark v. B.H. Holland Co., Inc.*, 852 F. Supp. 1268, 1274 (E.D.N.C. 1994) (ruling that under North Carolina law, failure to comply with statutory procedures required for corporate merger constitutes breach of director's fiduciary duty as well as breach of majority shareholders' duty to minority); *Ueltzhoffer v. Fox Fire Dev. Co., Civ. A. Nos. 9871, 9900, 1991 WL 271584*, at \*7, (Del. Ch. Dec. 19, 1991) (recognizing the *Wilkes* holding in Delaware in the context of close corporations); *Graham v. Mimms*, 444 N.E.2d 549, 561 (Ill. App. Ct. 1982) (finding that the fiduciary duties a controlling shareholder owed corporation and minority shareholders did not cease when he resigned as officer and director and installed his sister and brother-in-law in those positions); *G & N Aircraft, Inc. v. Boehm*, 743 N.E.2d 227, 240 (Ind. 2001) (ruling that the trial court correctly concluded that shareholders in a close corporation owe each other duties analogous to partners in a partnership); *Connolly v. Bain*, 484 N.W.2d 207, 211 (Iowa Ct. App. 1992) (stating that majority shareholders have the right to control the affairs of a corporation, if done so lawfully and equitably, and not to the detriment of minority stockholders); *Moore v. Me. Indus. Servs., Inc.*, 645 A.2d 626, 628 (Me. 1994) (holding that a statutory duty of good faith applied to majority shareholders who act as directors under corporation's bylaws in an action brought by a minority shareholder); *Toner v. Balt. Envelope Co.*, 498 A.2d 642, 653 (Md. 1985) (analyzing whether minority shareholder's rights were infringed when majority shareholders purchased her stock at a different price); *Zimmerman v. Bogoff*, 524 N.E.2d 849, 853 (Mass. 1988) (holding that a joint venturer who acted in bad faith was liable to fellow venturer and fellow venturer's corporation for his fiduciary breach); *Gunderson v. Alliance of Computer Prof'ls, Inc.*, 628 N.W.2d 173, 191 (Minn. Ct. App. 2001) (stating that minority shareholder's expectations of continuing employment must be balanced against the controlling shareholder's need for flexibility to run the business in a productive manner); *Daniels v. Thomas, Dean & Hoskins, Inc.*, 804 P.2d 359, 366 (Mont. 1990) (citing *Wilkes* in a case involving majority shareholder's purchase of minority shareholder's stock); *Walta v. Gallegos Law Firm, P.C.*, 40 P.3d 449, 457 (N.M. Ct. App. 2001) (stating that New Mexico's partnership case law provides a ready source of precedent supporting the *Wilkes* rule); *Ingle v. Glamore Motor Sales, Inc.*, 535 N.E.2d 1311, 1315 (N.Y. 1989) (Hancock, J., dissenting) (arguing that the majority's decision rejected without reason plaintiff's underlying rights as a minority shareholder in a close corporation); *Crosby v. Beam*, 548 N.E.2d 217, 221 (Ohio 1989) (stating that Ohio courts have found a heightened fiduciary duty between majority and minority

respect to the obligation that those in control owe to minority shareholders in closely held corporations.

Even in publicly held corporations, where the analogy to a partnership is inapposite, courts have recognized that a controlling shareholder owes a fiduciary duty to its subsidiary when there are parent-subsidiary dealings.<sup>28</sup> Delaware courts impose on the controlling shareholder the burden of proving the “intrinsic”<sup>29</sup> or “entire”<sup>30</sup> fairness of the transaction. Fairness includes not just the fairness of a price but also fair dealing.<sup>31</sup> An Illinois court, in interpreting Delaware law, recently reversed summary judgment for the defendant majority in litigation challenging a restructuring of the Chicago Board of Trade (“CBOT”) in which the majority members (“FM”) received five times as many shares in a new entity as the minority members (“AM”). The court first held: “A majority shareholder, or a group of shareholders who combine to form a majority, has a fiduciary duty to the corporation and to its minority shareholders if the majority shareholder dominates

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shareholders in close corporations); *Zidell v. Zidell, Inc.*, 560 P.2d 1091, 1094 (Or. 1977) (recognizing majority shareholder’s fiduciary duty to minority shareholder, but not requiring corporation to tailor its policies to favor minority shareholder at the expense of the majority); *Hendrickson v. Vandling*, 41 Pa. D. & C.3d 568, 575–78 (Pa. C.P. 1983) (stating that the distinction between partnership law and business corporation law is generally unimportant when dealing with oppressive conduct on the part of majority stockholders of close corporations); *Tomaino v. Concord Oil of Newport, Inc.*, 709 A.2d 1016, 1021 (R.I. 1998) stating that Rhode Island has adopted a similar rule to the *Wilkes* rule); *Nelson v. Martin*, 958 S.W.2d 643, 648 (Tenn. 1997) (analyzing whether the *Wilkes* rule should be applied to cases involving employment decisions); *Solomon v. Atlantis Dev., Inc.*, 516 A.2d 132, 136 (Vt. 1986) (adopting the *Wilkes* rule requiring a duty of loyalty and good faith on part of controlling shareholders); *Masinter v. WEBCO Co.*, 262 S.E.2d 433, 441 (W.Va. 1980) (recognizing the fundamental proposition that the majority stockholders in a corporation owe a fiduciary duty to the minority, as do the officers and directors); *McVeigh v. Grum*, 616 N.W.2d 524, 524 (Wis. Ct. App. 2000) (citing *Wilkes* as factually similar to a previous Wisconsin case involving shareholder employment rights).

28. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 719–20 (Del. 1971) (opining that where a transaction involves a parent and subsidiary the test should be that of intrinsic fairness and not the business judgment rule).

29. *Id.*

30. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (discussing the need for entire fairness with regards to a transaction and stating that this requirement is not diluted where there is a parent-subsidiary relationship).

31. *Id.* at 711.

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.

*Id.*

the board of directors and controls the corporation.”<sup>32</sup>

In the CBOT case, the reference to majority and minority did not refer to shares of the same class but rather different classes of interests. The challenge was to determine the relative values of the interests. In reviewing the evidence the court observed:

Significantly, the record shows that the median market value of an FM seat during the period 1995 to 1999 was only 1.87 times greater than the median market value of an AM seat during the same period. Further, testimony established that trading volume is one of the ingredients in determining share value; AM volume exceeds that of FMs; and minority members generated more than sixty percent of CBOT’s volume total from 1997 to 2001. Nevertheless, FMs would be allocated five shares for each AM share in the proposed CBOT, which adds to the question of fairness in light of the 1995 to 1999 median market values of CBOT seats and minority trading volume.<sup>33</sup>

The court then concluded that the plaintiffs were entitled to an entire fairness hearing to determine whether the allocation of equity interests among the membership classes was fair.<sup>34</sup>

Let us now look at LLCs. One would think that, when the LLC form of organization came into prominence, legislatures and courts would follow the teachings of *Donahue* and *Wilkes* and their progeny and recognize that members in an LLC have fiduciary duties to each other akin to those of partners in a partnership. After all, an LLC is a hybrid form of organization, having both partnership and corporate characteristics. LLCs have limited liability<sup>35</sup> like corporations,<sup>36</sup> but have limitations on transferability<sup>37</sup> and direct member management<sup>38</sup> as in a partnership,<sup>39</sup> rather than free transferability<sup>40</sup> and management being delegated to representatives as in a corporation.<sup>41</sup> LLCs are also

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32. Feldheim v. Sims, 800 N.E.2d 410, 421 (Ill. App. Ct. 2003).

33. *Id.* at 423.

34. *Id.*

35. See 805 ILL. COMP. STAT. 180/10-10 (2002) (limiting the liability of members and managers of an LLC to the company).

36. See 805 ILL. COMP. STAT. 5/6.40 (2002) (stating that generally, a shareholder of a corporation has no objection to the corporation or its creditors other than the obligation to pay full consideration for the shares received).

37. See 805 ILL. COMP. STAT. 180/15-1(c)(6), 30-5 (2002) (stating that admission of a new member requires the consent of all members and that a transfer of distributional interest does not entitle the transferee to become, or to exercise any rights of, a member).

38. See 805 ILL. COMP. STAT. 180/15-1(a)(1) (2002) (discussing member rights and obligations in a member-managed, as contrasted with a manager-managed LLC).

39. 805 ILL. COMP. STAT. 205/18(e)(g), 206/401(f), (i) (2002).

40. 805 ILL. COMP. STAT. 5/6.55 (2002).

41. See 805 ILL. COMP. STAT. 5/8.05 (2002) (assigning management of the business and



eligible to be taxed as partnerships.<sup>42</sup>

Unfortunately, the National Conference of Commissions on Uniform State Laws (“NCCUSL”) has placed the question of whether a member owes a fiduciary duty to another member in doubt.<sup>43</sup> The Uniform Limited Liability Company Act (“ULLCA”), drafted by NCCUSL, provides that “[t]he *only* fiduciary duties a member owes to a member-managed company *and its other members* are the duty of loyalty and the duty of care . . . imposed by subsection (b).”<sup>44</sup> Subsection (b) then provides:

(b) A member’s duty of loyalty to a member-managed company and its other members is *limited* to the following: (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company’s business or derived from a use by the member of the company’s property, including the appropriation of a company’s opportunity; (2) to refrain from dealing with the company in the conduct or winding up of the company’s business as or on behalf of a party having an interest adverse to the company; and (3) to refrain from competing with the company in the conduct of the company’s business before the dissolution of the company.<sup>45</sup>

An examination of subsection (b) reveals that clause (1) requires a member to account to the *company* if the member seizes an LLC opportunity, misappropriates LLC property, or makes a profit in the conduct or winding up of the LLC’s business. This archaic language was derived from the 1914 version of the Uniform Partnership Act<sup>46</sup> and, while not a paradigm of clarity, clearly does not provide recourse to a member who has been disadvantaged by another member. The prohibited actions involve wrongs done to the LLC, not a member.

Clause (2) is even more cryptic as it requires a member “to refrain from dealing with the [LLC] . . . as . . . a party having an interest adverse to the [LLC].”<sup>47</sup> Requiring a member not to deal with the LLC

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affairs of the corporation to a board of directors).

42. See Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. LAW. 499, 500 (2001), and text accompanying notes 6–9 (explaining the resurgence in legislative activity creating LLCs and why the LLC often became the entity of choice for new businesses).

43. *Id.* at 535–38.

44. See UNIF. LTD. LIABILITY CO. ACT § 409(a) (amended 1996), 6A U.L.A. 464 (1995) (outlining the fiduciary duties a member owes to a member-managed company and its members) (emphasis added).

45. UNIF. LTD. LIABILITY CO. ACT § 409(b) (amended 1996), 6A U.L.A. 464 (1995) (emphasis added).

46. UNIF. PARTNERSHIP ACT § 21 (1914), 6 U.L.A. 608 (1995).

47. UNIF. LTD. LIABILITY CO. ACT § 409(b)(2) (1995).

would seem clearly inconsistent with Section 409(f) of the ULLCA which provides that a member “may lend money to and transact other business with [the LLC].”<sup>48</sup> How can you both “transact business with” and “refrain from dealing with” the LLC? Proponents of the ULLCA suggest that the two provisions, when read together, require only that the member act fairly when dealing with the LLC. If that is the case, why not say so with clarity, rather than obfuscate the issue? But, in any event, clause (2) again deals only with a member’s actions toward the LLC, not toward other members.

Finally, clause (3), which prohibits a member from competing with the LLC,<sup>49</sup> once again deals with a member vis-à-vis the LLC, not with a member’s actions with regard to another member.

Because these provisions are exclusive and deal only with duties a member owes to the LLC, they effectively eliminate duties that controlling members owe to other members. While Section 409(d) imposes an obligation of “good faith and fair dealing”<sup>50</sup> when members deal with each other, this arguably is not a fiduciary duty standard. In the corporate context, courts have spoken of good faith and fairness as fiduciary concepts. But subsections (a) and (b) of Section 409 provide that these subsections are the exclusive source of fiduciary duties. Thus, Section 409(d) must set forth a commercial law standard of good faith and fair dealing, which is very minimalist, as opposed to a fiduciary standard.

The mischief that this inept drafting by the NCCUSL can cause is illustrated by the Tennessee case of *McGee v. Best*.<sup>51</sup> McGee started an advertising agency and, when it was folded into an LLC, received a thirty-three percent interest. The operating agreement provided that a member could be removed for cause by a vote of “[seventy percent] of the remaining membership interests.”<sup>52</sup> One of the other members owed \$750,000 to a client and the client in turn owed \$553,000 to the LLC.<sup>53</sup> When McGee urged the member to pay his debt so that the LLC could get paid, the other members removed him and terminated his employment.<sup>54</sup>

Tennessee had a statute which, like ULLCA, provided only that a

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48. *Id.* at 409(f).

49. *Id.* at 409(b)(3).

50. *Id.* at 409(d).

51. *McGee v. Best*, 106 S.W.3d 48 (Tenn. Ct. App. 2002).

52. *Id.* at 52.

53. *Id.* at 53.

54. *Id.* at 54.

member owes a fiduciary duty to the entity.<sup>55</sup> The statute did not mention any fiduciary duty that a member would owe to another member. Since LLCs are creatures of statute, the court held that a member owes no fiduciary duty to another member. The court interpreted the operating agreement as requiring only seventy percent of the members *other than the member whose removal was sought*, and held that there can be no violation of the obligation of good faith and fair dealing when the other members were taking action authorized by the contract.<sup>56</sup>

The foregoing case illustrates the weakness of a statute that limits fiduciary duties of a member only to those owed to the entity and also illustrates the limited scope of a commercial good faith and fair dealing provision.

It may seem strange that a concept of “good faith” can have a different scope, depending upon whether it is viewed in a commercial or a fiduciary context. This apparent paradox is unwound when the differing natures of the commercial and fiduciary relations are examined. A commercial transaction typically involves (i) a transaction (ii) between legal strangers (iii) which is closed.<sup>57</sup> On the other hand, a fiduciary relationship involves (i) a relationship (ii) between legal associates (iii) which is open (i.e., ongoing).

As the *Donahue* court stated, the partnership relationship involves mutual dependency, with each member making a contribution which benefits the enterprise and the other partners.<sup>58</sup> This, in turn, gives rise to the duty of “utmost loyalty.” In contrast, in a simple commercial transaction, the parties come together, close the transaction, and go their separate ways. The parties deal at an arm’s length with each other. There is no ongoing relationship where each is dependent upon the

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55. TENN. CODE ANN. §48-240-102(a) (2002) provides:

(a) Fiduciary Duty of Members of Member-Managed LLC.

Except as provided in the articles or operating agreement, every member of a member-managed LLC must account to the LLC for any benefit, and hold as trustee for it any profits derived by the member without the consent of the other members from any transaction connected with the formation, conduct, or liquidation of the LLC or from any use by the member of its property including, but not limited to, confidential or proprietary information of the LLC or other matters entrusted to the member as a result of such person’s status as a member.

*Id.*

56. *McGee*, 106 S.W.3d at 67.

57. With respect to the covenant of good faith and fair dealing, the Seventh Circuit has stated that it “has never been an independent source of duties for parties to a contract” and that it merely “guides the construction of explicit terms in an agreement.” *Beraha v. Baxter Health Care Corp.*, 956 F.2d 1436, 1443 (7th Cir. 1992).

58. *Donahue*, 328 N.E.2d at 512.

other and where the relationship is one of trust and confidence. Moreover, the essence of a fiduciary relationship is that one party possesses power which can adversely affect the other party to a relationship. In contrast, in an arm's length transaction, both parties stand on equal footing.

When Illinois updated its Limited Liability Company Act in 1998,<sup>59</sup> it essentially adopted most of the ULLCA, with the exception of its fiduciary duty provisions. Illinois both cleaned up the conflicting and ambiguous language of the ULLCA<sup>60</sup> and explicitly provided that the enumerated fiduciary duties were not exclusive.<sup>61</sup> Consequently, good faith and fair dealing are not limited to a commercial approach, but implicate fiduciary relationships. Were Illinois to consider the fact situation with which the Tennessee court dealt in *McGee v. Best*, the court would likely find that termination of a member by the other members violated their duty to act toward such member with the utmost good faith and loyalty.

For the law to be respected, it must generally produce results that accord with the community's notions of good faith and fair dealing. This would not appear to be the situation in the *McGee* case in Tennessee, which permitted termination of the minority's employment, office, or directorship when the minority sought to protect the enterprise. *McGee* incorporated the maxim "no good deed goes unpunished" quite literally into the law. Far better is a body of law, such as that in Illinois and most states, which encourages members to be mindful of their obligation to act in good faith and deal fairly with each other.

Other than in states which have adopted the ULLCA, I would expect courts in the LLC area also to follow the lead of *Donahue* and *Wilkes*, and hold that members in an LLC owe fiduciary duties to one another akin to those that partners owe to one another. After all, the law of fiduciary duty is one that has developed at the common law, rather than by statute, and, unless a statute negates fiduciary duties, it is the responsibility of the courts to hold members to the standard of good faith, loyalty, and fair dealing. Even in Tennessee, a year after *McGee*, another panel of the court, in *Anderson v. Wilder*, looked to the common law and held that members of an LLC do have a fiduciary relation with

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59. 1998 Ill. Legis. Serv. 90-424 (West) (codified as amended at 805 ILL. COMP. STAT. 180/1-1 *et seq.* (2002)).

60. See Murdock, *supra* note 42, at 526-38 (explaining the flaws of the ULLCA and how Illinois remedied them).

61. 805 ILL. COMP. STAT. 180/15-3(a), (b) (2002).

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each other.<sup>62</sup> This is a more appropriate approach to take as the law of LLCs develops.

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62. Anderson v. Wilder, No. E2003-00460-COA-R3-CV, 2003 WL 22768666 (Tenn. Ct. App. Nov. 21, 2003).