LLC's Majority Member May Owe Fiduciary Duties to Minority Members

Executive Summary

In a recent decision, the Massachusetts Supreme Judicial Court (SJC) held that the majority member of a Massachusetts limited liability company (LLC) was subject to the same fiduciary duties as a majority shareholder in a Massachusetts close corporation. The court based its conclusion on a review of the operating agreement of the LLC in question, finding that it included protections similar to those afforded to close corporation minority stockholders.

This case will have lasting implications for both current and prospective business owners as they decide how to structure organizations and what provisions to include in their operating agreements.

Background

The case of *Allison v. Erikson*, 479 Mass. 626 (2018), stemmed from a dispute between the two founding members of a Massachusetts limited liability company. Initially, the LLC was owned by just two founders, with the majority member (Majority Holder) owning 75% of the membership interests, and the minority member (Minority Holder) owning 25%. As the LLC added additional members over time, the founding members amended the LLC's operating agreement to provide, among other things, that the Minority Holder's consent was required to add new members, to dilute the Minority Holder's interest, and to further amend the operating agreement. Yet, only a vote of 60% of the outstanding equity was required to make significant business decisions, allowing the Majority Holder to make such decisions without the Minority Holder's consent. Importantly, the operating agreement did not in any way waive or limit the fiduciary duties of the LLC's manager or members.

Later, the LLC became short on funds. The Majority Holder, without the Minority Holder's knowledge, developed a plan to circumvent the Minority Holder's veto rights under the operating agreement. Creating a new Delaware-based LLC, the Majority Holder merged the Massachusetts LLC into the Delaware entity.

The new Delaware LLC's operating agreement differed substantially from that of the Massachusetts LLC. It created a new class of preferred equity with priority over the common interests. It required a majority vote of the outstanding equity to elect a board of directors charged with managing the company, effectively giving the Majority Holder the right to appoint the entire board. It limited members' rights to inspect the company's books and records or receive information about the company. And it waived fiduciary duties to the extent permitted by Delaware law. As a minority common holder of the new Delaware LLC, the Minority Holder had virtually no opportunity to participate. Further, following the merger, the Majority Holder invested close to an additional $1,000,000 in the Delaware LLC in exchange for preferred equity, diluting the Minority Holder's interest down to only 3.3%. After several unsuccessful attempts to negotiate a resolution, the Minority Holder sued for, among other things, breach of fiduciary duty related to the Majority Holder's orchestration of the merger.

SJC Findings

On appeal, the SJC found that the Majority Holder had violated his fiduciary duties by consummating the merger of the Massachusetts LLC into the Delaware entity. The Court highlighted that, despite Massachusetts law allowing for the limitation of fiduciary duties in an LLC agreement, the Majority Holder and Minority Holder had built significant minority protections into the Massachusetts LLC's operating agreement. Looking to Massachusetts law governing fiduciary duties in close corporations, the court determined that the Majority Holder's decision to merge the Massachusetts LLC into the Delaware LLC was a breach and in contravention of the Minority Holder's rights both under the operating agreement and in equity. The SJC, therefore, upheld the lower court's decision to amend the Delaware LLC's operating agreement to reinstate the Minority Holder's protective rights and increase his interest back to 5%.

SJC Guidance on Interpreting Members Responsibilities in LLC

The *Allison* decision provides guidance on how the SJC will interpret majority members' responsibilities to their minority counterparts in the LLC context. On the one hand, it confirms that members may limit fiduciary duties so long as the language of their operating agreement is clear. On the other hand, it establishes that, in the absence of such limitation, Massachusetts courts may impose fiduciary duties on majority members, even where such duties are only implicit in an operating agreement. In some instances, as was the case here, the court may then equitably amend the operating agreement to incorporate minority protections.

Of particular note, the SJC in *Allison* looked to the specific provisions of the LLC operating agreement to determine whether members of the LLC owed each other the strict fiduciary duties that Massachusetts courts have imposed among shareholders of close corporations. A prior decision from the SJC had suggested that the Court would treat LLC's as akin to close corporations in which such duties are owed as long as the LLC met the traditional definition of a close corporation: having (1) a small number of members, (2) no ready market for membership interests, and (3) substantial majority member participation in the management, direction, and operations of the company. See *Pointer v. Castellani*, 455 Mass. 537, 549 (2009) (applying these criteria to conclude that an LLC was a close corporation). In *Allison*, however, the SJC clarified that "[t]he test for whether a corporation is closely held . . . is not dispositive for determining whether an LLC is closely held." Because "LLCs are creatures of contract," the Court instead declared that "determining whether an LLC is closely held is a more fact-specific determination that will depend on the way in which a particular LLC is structured." The structure of the

Massachusetts LLC in *Allison*, and particularly the numerous protections the operating agreement afforded to the minority member, led the SJC to conclude that it was akin to a close corporation in which members owed each other strict fiduciary duties.

Takeaways for Business Owners

1. Governing Agreements: While business owners should always be careful to know and understand what their governing agreements say, *Allison* provides a stark reminder of how important it is to do so. Had the Majority Holder thought through the implications of the various minority veto rights built into the Massachusetts LLC's operating agreement, he may have been able to reach a negotiated resolution with the Minority Holder well before the company was in dire need of cash. Not doing so ultimately led to his ill-advised decision to freeze out the Minority Holder and the finding that he had not acted in good faith.

2. Members' Rights and Duties: The case also provides guidance on the types of provisions that courts will consider relevant in analyzing majority member duties. The SJC specifically drew attention to the Minority Holder's rights to veto (i) the admission of new members, (ii) the dilution of his equity stake, (iii) and the amendment of the operating agreement. The Court viewed these points as fundamental to the members' understanding of their rights and duties.

3. Intention vs. Interpretation of Minority Protections: Business owners undertaking a new venture should consider the implications of *Allison* in preparing their operating agreements. And those who already have an operating agreement in place should review it in the wake of *Allison* to ascertain what minority protections it contains and whether the full scope of those protections is what the members intend. If certain protections have become outdated or were not intended originally, members should consider how to address those points before they become grounds for a dispute.

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