

AVOIDING A LIMITED FUTURE FOR THE DE FACTO LLC AND LLC BY ESTOPPEL

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I. INTRODUCTION

Entrepreneurs, courts and scholars have long grappled with the problem of defects arising in the course or process of organizing a business. Promoters' failure to follow all the steps designated by statute for the valid existence of their business entity of choice exposes the owners of the putative, but officially non-existent, entity to personal liability for contractual obligations incurred in its name or torts committed in the course of its business.¹ Other pertinent questions pertain to whether the "entity"

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1. For example, notwithstanding the simplification of the process of incorporation, many incorporators fail to comply with the minimal statutory requirements for a valid incorporation of a business enterprise. See JESSE H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, *CASES ON MATERIALS ON CORPORATIONS* 241-242 (7th ed. 2008) ("As appellate decisions continue to indicate, problems arise when a business enterprise purports to be incorporated but in some way has not fulfilled the statutory requirements for the process of incorporation."). For cases illustrating recent manifestations of the problem, see *Milligan v. Milligan, et al.*, 956 So. 2d 1066, 1074 (Ct. App. Miss., 2007) (discussing a contention that the business "was a de facto corporation and thus had the legal ability to acquire ownership interest and title to property"); *Pharmaceutical Sales Consulting Corp. v. Accucorp Packaging, Inc.*, No. 95-5961, 2007 WL 4259998 (D.N.J. Nov. 30, 2007) (discussing the de facto and estoppel concepts but holding them inapplicable in the particular case); *Black Car and Livery Insurance, Inc. v. H & W Brokerage, Inc.*, No. 8615-04, 2007 WL 914196 at *3 (N.Y. Sup. Ct. March 8, 2007) (discussing incorporation by estoppel and rejecting de facto status for purported corporation because "it never attempted to comply with the statutory requirements regarding incorporation"); *Jade Sterling Steel Co.*

can receive or make conveyances of property, maintain a suit or be sued in its own name, and whether investors will be able to rely on a lack of formal organization to avoid obligations to innocent third parties.² The new battleground for this perennial problem is the limited liability company (“LLC”). Within a short span since the entrance of this form of business association into the American legal landscape in 1977 with the passage of the Wyoming statute,³ the LLC has seen a meteoric rise as the business form of choice for many investors.⁴ The rise in popularity of the LLC has been accompanied by a corresponding call for regulatory guidance.⁵ One area that begs for such guidance is pre-organization liability.⁶

v. Stacey, No. 88283, 2007 WL 416697 (Ohio App. Ct. Feb. 8, 2007) (holding that even though the defendant claimed his attorney had filed articles of incorporation, there had been no good faith effort to incorporate); Bishop v. Murphy, No. 05A-05-002, 2006 WL 1067274 (Del. Sup. Ct. April 10, 2006) (holding that while it could only speculate as to why the incorporation process was not completed, the business had satisfied the criteria for a de facto corporation status.); Grabarek v. J’s Const. & Masonry, Inc., No. CV000092444S, 2002 WL 1837845 (Conn. Sup. Ct. July 8, 2002) (holding that the defendant had taken good faith steps towards incorporation and deeming defendant a de facto corporation).

2. James D. Cox & Thomas Lee Hazen, *Corporations* 90-91 (2d ed. 2003).

3. See generally Robert R. Keatinge, et al., *The Limited Liability Company: A Study of an Emerging Entity*, 47 BUS. LAW. 378 (1992) (examining the rekindled interest in unincorporated organizations that limit the liability of their owners to their investment); Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1 (1995) (describing the main features of LLCs); Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393 (1996) (elucidating several criticisms of the LLC model); Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459 (1998) (examining the preceding events behind the acceptance of the LLC organization as a viable option); Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or not) from Close Corporations*, 40 WAKE FOREST L. REV. 883 (2005) (concluding that the problems of minority shareholder oppression that exist under a close corporation also exist in LLC settings); Natalie Smeltzer, *Piercing The Veil of a Texas Limited Liability Company: How Limited is Member Liability?*, 61 SMU L. REV. 1663, 1664 (2008) (discussing the application of corporate veil piercing to LLCs in Texas state courts).

4. See Mirit Eyal-Cohen, *When American Small Business Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950s*, 6 PITT. TAX REV. 1, 5 (2008) (“Today, we observe a steady increase in the number of LLCs. . . .”); Howard M. Friedman, *The Silent LLC Revolution – The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35 (2004) (describing the LLC as a new dominant form of business organization for small businesses); Larry E. Ribstein, *LLCs: Is the Future Here?*, 13 BUS. LAW TODAY 11 (Nov./Dec. 2003) (examining the rise in popularity of LLCs); Larry E. Ribstein, *The New Choice of Entity for Entrepreneurs*, 26 CAP. U.L. REV. 325 (1997) (describing the LLC’s rise and its implications).

5. Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 VA. L. & BUS. REV. 35, 36 (2008) (making reference to “the rapid rise in LLC filings and corresponding increase in the demand for guidance in the regulation of the LLC form”).

6. A whole range of pre-formation questions, mirroring the situation with corporations, is expected to arise with LLCs as they continue to grow in number, usage and influence. See Dustin R. Darst, *Corporate Pre-Organization Liability in an LLC World*, 61 ARK. L. REV. 301 (2008) (stating that the issue of pre-organization liability of individuals

In the older forms of business organization, the courts stepped in to remedy the problems occasioned by defective organization by cloaking the owners with limited liability that a proper organization traditionally affords and recognizing the validity of the contracts.⁷ This investiture has been accomplished through the doctrines of de facto corporation, corporation by estoppel, and analogous concepts in general and limited partnership law.⁸ This article argues for a similar treatment for LLCs, mindful of the resistance that has trailed the application of these concepts to the earlier business forms and the cold reception that has greeted their recognition in

“has grown in importance in Arkansas and around the country as the majority of new firms and businesses opt to form as LLCs”); William J. Rands, *High Pressure Sales Tactics and Dead Trees: What to do with Promoters’ Pre-incorporation Contracts*, 4 RUTGERS BUS. L.J. 1, 38 n.133 (2007) (stating that “LLCs are so similar to corporations, especially as to the method of formation and the doctrine of limited liability for its owners, it is inevitable that the pre-formation issues will soon arise.”).

7. It should be noted that this problem is not limited to initial formation but also arises in the case of continuation of business in the entity name after expiration, revocation or forfeiture of the corporate charter or similar organizational status. *See generally*, N. Kenova Dev. Co., v. Wilson, No. 08CA6, 2008 WL 5077648 (Ohio App. Ct. Nov. 21, 2008) (discussing effect of operating after cancellation of corporate charter); City of Cincinnati v. York Masons Bldg. Ass’n, Nos. C-080003, C-080019, 2008 WL 3878320 (Ohio App. Ct. Aug. 22, 2008) (holding that reinstatement of cancelled articles of incorporation permitted a corporation to operate as a de facto corporation); *In re Estate of Woodroffe*, 742 N.W.2d 94, 102 (Iowa 2007) (holding that “once a de jure corporation’s term of existence [ends] pursuant to its charter, it [cannot] continue to exist as a de facto corporation or corporation by estoppel.”); *Stevenson Lumber Suffield, Inc. v. Winloc, Inc. et al.*, No. CV065000568S, 2007 WL 4637140 (Conn. Sup. Ct. Dec. 7, 2007) (noting that a dissolved corporation may be recognized as a de facto corporation under certain limited circumstances); *Briarpatch Ltd., L.P. v. Geisler Roberdeau, Inc.*, No. 99 Civ. 9623, 2007 WL 1040809 at *17 (S.D.N.Y. Apr. 4, 2007) (noting that post-dissolution of corporate powers qualifies a dissolved corporation as a de facto corporation); *Lodato v. Greyhawk N. Am., LLC*, 834 N.Y.S.2d 237, 239 (N.Y. App. Div. 2007) (holding that a dissolved corporation had neither de jure nor de facto existence and those purporting to act on behalf of such corporation are personally responsible for obligations incurred, unless they acted without actual knowledge of the dissolution); *Orix Fin. Serv., Inc. v. Leclair*, No. 05-CV-9405KMK, 2007 WL 633706 (S.D.N.Y. Feb. 26, 2007) (operating under a revoked charter); *Nationwide Airlines (Pty) Ltd. v. Afr. Global, Ltd.*, No. 3:04 CV 00768, 2007 WL 521155 (D. Conn. Feb. 14, 2007) (granting de facto corporation status to a corporation that was dissolved and reinstated); *Nw. Med. Imaging, Inc. v. Alaska Dep’t. of Revenue*, 151 P.3d 434 (Alaska 2006) (holding that there was a de facto corporation even after administrative dissolution); *Definitive Res., Inc. v. United States*, No. DKC 2005-3233, 2006 WL 3423854 (D.Md. Nov. 28, 2006) (discussing de facto and estoppel concepts where corporate charter had been revoked).

8. *See* Wayne N. Bradley, *An Empirical Study of Defective Incorporation*, 39 EMORY L.J. 523, (1990) (studying the history and policy behind de facto incorporation and defective incorporation); Douglas C. Waddoups, *American Vending Services, Inc. v. Morse: The Problem of Defective Incorporation in Utah*, 1995 B.Y.U. L. REV. 303 (“In an attempt to protect shareholders who inadvertently fail to comply with the formalities of incorporation, the common law developed the doctrines of de facto corporations and corporation by estoppel, which, when applicable, protected shareholders and third parties dealing with defectively formed corporations.”)

the LLC context.

The Uniform Limited Liability Company Act,⁹ the Revised Uniform Limited Liability Company Act,¹⁰ and the Prototype Limited Liability Company Act¹¹ are remarkably silent on the issue of defective formation,¹² presumably leaving the question of the status of members of such LLCs to the nebulous notion of “the principles of law and equity.”¹³ Some courts, responding to the problem, have adopted a “de facto corporation” or “corporation by estoppel” analysis in shielding the organizers of the LLC from liability.¹⁴ This is not entirely surprising. As has been counseled, “[g]iven the parallels between limited liability company organization and incorporation, the courts may well look to the corporate jurisprudence for guidance.”¹⁵ Notable commentators have also started weighing in on the need to recognize de facto LLCs and LLCs by estoppel.¹⁶ According to Ribstein and Keatinge:

A firm that has not been properly formed as an LLC . . . might be recognized as having been technically formed—that is, as a “de facto” LLC—even in the absence of proof of filing. Some LLC statutes provide that the firm may not transact business prior to formal existence or that parties who assume to act as an LLC prior to formation are personally liable for debts. Such provisions are questionable to the extent that they result in nonenforcement of preformation deals contrary to the parties’ clear expectations. Accordingly, the law probably should permit the recognition of

9. Unif. Ltd. Liab. Co. Act (1996).

10. Rev. Unif. Ltd. Liab. Co. Act (2006).

11. Am. Bar Ass’n Prototype Ltd. Liab. Co. Act (1992).

12. See also GLENN G. MORRIS & WENDELL H. HOLMES, 8 LOUISIANA. CIVIL LAW TREATISE, BUSINESS ORGANIZATIONS § 44.05 (2009) (“Except for the rules concerning the effects and timing of a certificate of organization, the LLC statute says nothing about the liability of a promoter of an LLC for pre-formation contracts, or about the liability of a participant in a purported LLC that was not properly formed at the time the liability arose.”)

13. Daniel S. Kleinberger, *A User’s Guide to the New Uniform Limited Partnership Act*, 37 SUFFOLK U. L. REV. 583, 625 (2004).

14. See cases discussed in Part IV below. See also Elizabeth S. Miller, *Are the Courts Developing a Unique Theory of Limited Liability Companies or Simply Borrowing From Other Forms?* 42 SUFFOLK U. L. REV. 617, 631 n. 67 (2009) [hereinafter Miller, *Unique Theory*] (“Courts have consistently borrowed principles developed in the corporate context regarding de facto incorporation, corporation by estoppel, and promoter liability in cases that involve transactions in the LLC name prior to the filing of the articles of organization.”).

15. Matthew G. Dore, 5 Iowa. Practice Series: Business Organizations § 13:3 (2007).

16. See CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 6.02[2][d][i] (2008) (“The de facto doctrine should apply to limited liability companies as well as to corporations.”) See also *id.* ¶ 6.02[2][d][ii] (“The analysis that supports applying the de facto doctrine to limited liability companies also supports the concept of ‘limited liability company by estoppel.’”)

LLCs “by estoppel.”¹⁷

The authors of a major treatise on business organizations have also noted that a “group of persons who associate with the intent of becoming . . . [an] LLC but who do not file the appropriate original document could be . . . considered [an] LLC by estoppel. The concept of a de facto LLC is still evolving . . .”¹⁸ It is imperative to undertake a closer examination of the evolution of the de facto and estoppel concepts in the LLC context and ensure that the development is not derailed.

This work has surveyed judicial and legislative trends in the development and application of the notion of de facto LLCs and LLCs by estoppel in all the 50 states and the District of Columbia, with the influence of the precursor counterpart concepts in corporate and partnership law in the background. It observes that while some states appear to be comfortable with the concepts of de facto LLC and LLC by estoppel, others have not embraced them.¹⁹ In states that have either categorically rejected these defensive doctrines or made no provisions for their application, the import may be that not only are the individuals behind the businesses unlimitedly liable, but also the LLCs are unable to enforce the contracts even when they eventually come into existence. Describing the extant state of the law, one commentator has observed:

Another concern that may arise with respect to transactions made on behalf of a limited liability company before it is organized is whether the company can enforce those transactions once the company’s organization is complete. Some courts have held that a limited liability company acquires no rights under contracts or

17. Larry E. Ribstein & Robert R. Keatinge, 1 Ribstein And Keatinge On Limited Liability Companies, §4:15 (June 2009).

18. ROBERT R. KEATINGE & ANN E. CONAWAY, KEATINGE AND CONAWAY ON CHOICE OF BUSINESS ENTITY: SELECTING FORM AND STRUCTURE FOR A CLOSELY HELD BUSINESS § 3:7 (2009).

19. See e.g., Peter D. Hutcheon, *The New Jersey Limited Liability Company Statute: Background and Concepts*, 18 SETON HALL LEGIS. J. 111, 131 (1993) (“An LLC may be formed under the New Jersey statute by filing a certificate of formation with the Secretary of State. Analogous to limited partnership law, there is no such thing as a de facto LLC.”); Jon T. Anderson, *National Business Institute: Examining And Resolving Title Issues*, 34539 NBI-CLE 131, app. at 161 (2006) [hereinafter Anderson, *Title Issues*] (stating that in Vermont, “there is presently no judicially recognized concept of a de facto limited liability company as there is with respect to corporations.”); Robert W. Hamilton, Elizabeth S. Miller & Robert A. Ragazzo, *The Formation of Limited Liability Companies*, 20 TEX. PRAC. SERIES TM: BUS. ORG. § 19.4 (2d ed.) (2008) (doubting the possibility of the “application of a ‘de facto LLC’ doctrine in the case of a failure to file the articles of organization” in Texas); SUSAN KALINKA, 9 LA. CIV. L. TREATISE, LLC & PARTNERSHIP BUS. & TAX PLAN § 1.4 (3d ed. 2008) (raising the possibility that in Louisiana, members of an LLC whose articles had been revoked or which does not have the relevant documents on file with the secretary of state “can successfully assert an argument that the organization is a *de facto* limited liability entity or that a limited liability entity exists by estoppel”)

conveyances in its name if the company did not exist at the time the contract or conveyance was made. Absent a special law validating such contracts or conveyances, arguments that the transactions are valid under a “de facto limited liability company” or “limited liability company by estoppel” theory have met with only limited success.²⁰

A central mission of this article is the transformation of the above picture through a presentation of a compelling case for the universal application of the de facto LLC and LLC by estoppel concepts to pre-formation contracts. The article also aims to extend the recognition of the defective organization concepts to cases where no contracts or conveyances were made (namely, appropriate cases in tort) and where no LLC was formed subsequent to the contract or conveyance. Generally, the doctrines should also be recognized in situations where one party seeks to impose personal liability on persons conducting business on behalf of an unformed LLC or where an unformed LLC and its managers seek to evade obligations after the business has been represented to a third party as an LLC. In summary, owners of improperly formed LLCs should enjoy limited liability protection when such investors, in good faith, believe that an LLC had been formed or where there have been dealings on the basis that an LLC is a party. This approach will simplify the application of the de facto and estoppel concepts while ensuring justice and fairness.

The Article is organized into six major parts. Part II is an introduction to the nature of the LLC business form and a possible explanation of its growing popularity. This development underscores the importance of examining the effect of the growth on the business sector and those that have dealings with LLCs. Part III presents a synopsis of the historical evolution and application of the concepts of de facto corporation and corporation by estoppel, including their attempted elimination and ultimate resurrection under the model corporation statutes. This part also discusses related concepts in other business forms, including de facto limited partnerships, limited partnerships by estoppel and general partnerships by estoppel. Part IV examines the journey of these concepts into the LLC arena and to what extent the hostility that surrounded them in the corporation and partnership contexts has survived or diminished in the context of LLCs. In that connection, statutory provisions and judicial decisions are discussed.

Part V, relying on a seven-fold rationale, proposes the adoption by all states of an assuming-to-act provision that incorporates a knowledge component. The import of the provision is to impose personal liability only on those who enter into pre-formation contracts or cause tortious injury to

20. DORE, *supra* note 16, at § 13.3.

third parties while acting as an LLC knowing there has been no proper formation, provided that those who present or accept a business as an LLC may not act contrary to that fact. In the same vein, innocent investors who have a passive role or operate under the erroneous belief that the business has been properly registered as an LLC would enjoy the same limited liability protection afforded those who comply fully with the pre-organization requirements.²¹ The adoption of the proposal will preserve the doctrines of de facto LLC and LLC by estoppel.²²

This approach strikes a balance and satisfies the need for fairness in protecting the interests of diligent creditors and credible investors. Alternative approaches would guarantee windfall profits to some creditors contrary to their contractual expectations or enable business owners in all cases to skirt statutory rules with impunity.²³ More specifically, the proposal emphasizes prudence in business policy, promotes compliance with statutory provisions, protects third parties who would benefit from the notice function that registration serves, secures land titles, obviates excessive or incommensurate punishment, reduces risk to innocent investors interested in doing business in the LLC form, and prevents extension of windfall profits to some creditors beyond their contractual expectations. Section B of this part applies the proposal to a number of scenarios by creating a taxonomy. The final section of Part V presents a critical appraisal of the proposal. Part VI concludes the critical task that this work has undertaken of illuminating judicial and legislative action regarding the birth of the defective organization doctrines in the LLC context and eliminating any tendency by the courts and legislatures to squash the march toward their adoption.

21. See Joseph L. Levinsohn, *Liability to Third Persons of Associates in Defectively Incorporated Associations*, 13 MICH. L. REV. 271, 282 (1915) (stating that it is “repugnant to the requirements of justice and the needs of the business community [to] subject the modest investor, who has purchased a few shares of stock in a great railroad, financial or industrial corporation which chanced to be defectively organized, to full personal liability for all the debts of the company”); Calvert Magruder, *A Note on Partnership Liability of Stockholders in Defective Corporations*, 40 HARV. L. REV. 733, 745 (1927) (stating a position against any disposition to make the law “lurk privily in dark places, intent upon ruining a person who, in the exercise of that degree of care which it is practicable to expect, makes an investment in the stock of a business organization that purports to be, and behaves as though it were, a *de jure* corporation”).

22. See Norwood P. Beveridge, *Corporate Puzzles: Being a True and Complete Explanation of De Facto Corporations and Corporations by Estoppel, Their Historical Development, Attempted Abolition, and Eventual Rehabilitation*, 22 OKLA. CITY U.L. REV. 935, 971 (1997) (stating that a similar provision in the Model Business Corporations Act restored the defective incorporation doctrines to the status quo before their attempted abrogation).

23. However, in some cases agency law may provide a basis for liability for those acting with knowledge that there is no LLC. See *id.* at 943 (stating principles of agency liability when representing a nonexistent principal).

II. NATURE AND POPULARITY OF THE LLC

The LLC is a relatively recent innovative business form that combines some of the most attractive features of a corporation (separate legal personality and limited liability) and those of a partnership (pass-through taxation and contractual flexibility). Put differently, the LLC is a hybrid business form, with partnership and corporate characteristics.²⁴ The hybrid nature of the LLC usually comes into focus in efforts to decipher the intention behind the provisions of LLC statutes. Courts rely on partnership or corporate principles depending on the source of the provision being construed.²⁵ The area of defective organization represents one—and perhaps the only—aspect of LLCs in which experiences from both partnerships and corporations may be simultaneously relevant.²⁶

In the past few years, the LLC indisputably has become the business organization of choice for many investors, especially those interested in small business. The popularity of LLCs is traceable to a number of factors, although a full explanation beyond the present-day speculation may still

24. See Ann K. Wooster, Annotation, Construction and Application of Limited Liability Company Acts – Issues Relating to Formation of Limited Liability Company and Addition or Dissociation of Members Thereto, 43 A.L.R. 6TH 611 (2009) (discussing the LLC form).

25. See *Meyer v. Oklahoma Alcoholic Beverage Laws Enforcement Comm'n*, 890 P.2d 1361, 1363-64 (Okla. Civ. App. 1995) (comparing the LLC form to a partnership or corporation and reasoning that since the LLC possesses the limited liability feature of a corporation and not the personal responsibility that attaches to partners in a general partnership, an LLC cannot hold a retail package store liquor license). See also *Anderson v. Wilder*, No. E2003-00460-COA-R3-CV, 2003 WL 22768666, at *4 (Tenn. Ct. App. Nov. 21, 2003) (describing an LLC as a hybrid between state partnership and corporation statutes).

[W]hen a court is interpreting an LLC act or agreement, the court will focus on the particular aspect of the LLC that gave rise to the problem, with emphasis on the foundational business form from which that characteristic originated. Usually, the particular aspect can be traced to either the corporate components or the partnership components of the LLC act or agreement. In such cases where the characteristic originated from the partnership aspects of the LLC, the court will use the established [principles] and precedent of the partnership law to resolve the issue . . . [.] In such cases where the characteristic originated from the corporate aspects of the LLC, the court will utilize the established [principles] and precedent of corporate law to resolve the issue.

Id. (quoting Annotation, Construction and Application of Limited Liability Company Acts, 79 A.L.R.5TH 689, 698 (2000)).

26. For a critique of the judicial approach of relying on precedent from the older business firms to resolve questions that arise in the LLC context, see Miller, *Unique Theory*, *supra* note 15, at 647 (commending the borrowing as an efficient way of not re-inventing the wheel but cautioning against the sort of reliance that inhibits the development of a unique LLC approach that takes into account variations of earlier provisions that are tailored to the LLC context).

take a few years to emerge.²⁷ LLCs are favored over corporations because they have pass-through taxation, instead of the double taxation characteristic of corporations.²⁸ LLCs also hold a distinct advantage over general partnerships because they provide investors with limited liability.²⁹ Although some other business forms, notably the S corporation and the limited partnership (“LP”), have stepped in to remedy the above two disadvantages of earlier business forms, LLCs still present a clear advantage over them.³⁰ In exchange for pass-through taxation, S corporations are saddled with a host of onerous restrictions, including a limitation on the number of shareholders to a maximum of 100, restriction to only one class of stock, non-admission of non-resident aliens as shareholders and restriction of shareholding generally to natural persons, with the exception of a few qualified estates and trusts.³¹ The LLC has none of these restrictions and is open to foreign investors, pension plans and corporate joint ventures.³²

Investors in LPs are not burdened with double taxation. The business form also provides for limited liability. However, not all the investors can enjoy that protection as there must be a general partner who always has unlimited exposure to personal liability. A corporate general partner

27. See Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 128 (2001) (showing no clear answers from the available evidence).

28. See generally D. GORDON SMITH & CYNTHIA A. WILLIAMS, *BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES* 143 (Aspen Publishers, 2d ed., 2008) (1962) (“Corporations also suffer from the dreaded problem of ‘double’ taxation – the notion that corporate profits are taxed once at the corporate level and then again at level of the individual shareholder after payment of dividends.”); Michael Doran, *Managers, Shareholders and the Corporate Double Tax*, 95 VA. L. REV. 517 (2009) (discussing corporate tax issues); Ryan Sklar, *Hedges or Thickets: Protecting Investors from Hedge Fund Managers’ Conflicts of Interest*, 77 FORDHAM L. REV. 3251, 3262 n.90 (2009) (noting the preference of pass-through taxation over double taxation).

29. See ELLEN S. FRIEDENBERG, ET AL., 3 SUCCESSFUL PARTNERING BETWEEN INSIDE AND OUTSIDE COUNSEL § 50:11 (Apr. 2009) (stating that members of an LLC have limited liability while partners in a general partnership have unlimited liability).

30. See Mary Elizabeth Matthews, *The Arkansas Limited Liability Company: A New Business Entity is Born*, 46 ARK. L. REV. 791, 792-93 (1994) (“The combination of those two attributes has been available previously in both the limited partnership and the S corporation formats. However, the LLC enjoys significant advantages over each of the alternatives.”).

31. See I.R.C. § 1361(b) (2004) (setting forth the tax structure of S corporations). Earlier provisions on the maximum number of shareholders were even more restrictive, with a limit of 35 shareholders prior to 1996, 75 shareholders from 1996 to 2004, and 100 shareholders since 2004 when Congress passed the American Jobs Creation Act of 2004. See MICHAEL T. MADUSIB, ET AL., 1 LAW OF REAL ESTATE FINANCING § 1:54 n.5 (Aug. 2009) (noting limitations in the number of shareholders in S corporations).

32. See Matthews, *supra* note 30, at 795 (pointing to the relaxations of ownership restrictions as the most important advantage of LLCs over S corporations).

(“CGP”) may be used to circumvent the personal liability problem, but not only is it still a more circuitous process than simply forming an LLC, but the LP may be taxed as a corporation in some situations.³³

The limited liability partnership (“LLP”) comes closest to paralleling the combination of the advantages of the LLC, including limited liability for all investors and absence of double taxation, while not necessarily embracing all the restrictions of the S corporation. However, the LLC has some advantages vis-à-vis the LLP. First, LLCs provide a full shield of limited liability. While LLPs in many states also provide a full shield, some states only provide a partial shield protecting partners from partnership obligations arising in tort, but not from contracts,³⁴ or covering both contracts and torts but imposing some form of limitation on the protection, such as supervisory liability.³⁵ Second, the LLC generally does not impose a burden of annual renewal, while the LLP needs to file an annual application for renewal of its certificate to maintain its limited liability status.³⁶ Moreover, there is also the concern among many lawyers that “the LLP shield is more ‘porous’ than the shield provided by corporations or limited liability companies. For example, does the principle that any change in membership in a partnership constitutes a termination of the old partnership and the creation of a new partnership affect the LLP election?”³⁷ In some states, LLPs are also required to obtain

33. The LP will be taxed as a corporation where the CGP does not have substantial assets that could be reached by a creditor or where the CGP is a mere shell acting as an agent of the limited partners. See Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083, 1103-04 (1992) (discussing the liability of Corporate General Partners in an LLC); Matthews, *supra* note 30, at 793 n.8 (discussing the same).

34. See e.g., UTAH CODE ANN. § 48-1-12 (1953) (exempting partners in LLPs from partnership obligations arising in tort); Fredric J. Bendremer, *Delaware LLCs and Veil Piercing: Limited Liability Has Its Limitations*, 10 FORDHAM J. CORP. & FIN. L. 385, 393 (2005) (discussing liability shields under various state LLC laws); Gregory Scott Crespi, *Choice of Law in Veil-Piercing Litigation: Why Courts Should Discard the Internal Affairs Rule and Embrace General Choice-of-Law Principles*, 64 N.Y.U. ANN. SURV. AM. L. 85, 127 n.130 (2008) (noting the same).

35. See TEX. BUS. ORG. CODE ANN. § 152.801(b) (providing that a partner in an LLP is liable for the tort of those under his supervision or where he participates in the activity in which the tort arose or where he was informed of tort and did not act to prevent or correct it); Kus v. Irving, 736 A.2d 946, 947 (1999) (construing Connecticut statute that imposes supervisory liability on partners in an LLP).

36. See MORRIS & HOLMES, *supra* note 12, at § 44.05 (“The LLC statute imposes no conditions to limited liability beyond the issuance by the secretary of state of a certificate of organization.”); Carol J. Miller, *LLPS: How Limited is Limited Liability?* 53 J. MO. B. 154, 156 (May/June 1997) (discussing filing requirements). It should be noted that an LLC statute may require the filing of annual reports by all LLCs in the state failing which an LLC may lose its status. See KALINKA, *supra* note 19 (discussing the applicable situation in Louisiana).

37. ROBERT W. HAMILTON & JONATHAN R. MACEY, *CASES AND MATERIALS ON*

and maintain a liability insurance policy or segregate funds in lieu thereof, which could be onerous on business start-ups.³⁸ Further, unlike an LLP, one person can form an LLC in most states thus making it possible for single entrepreneurs to adopt the form.³⁹ Not only is the LLP option foreclosed to such individuals, but opting for an LLC obviates the extra hassle of searching for compatible and reliable business associates. Finally, some states restrict the use of LLPs to professional firms, while the LLC may be adopted by people engaged in various forms of businesses.⁴⁰

None of the statements above should be construed as suggesting that the LLC is devoid of disadvantages in comparison to the other business forms. Because the LLC is relatively new, the law is still in development. This could create uncertainty and make many investors uncomfortable.⁴¹ In addition, a merger or other reorganization between an LLC and a larger publicly held corporation will be subject to taxes. If the transaction involves corporations only, it will be completed on a tax-free basis.⁴² Furthermore, LLCs face franchise taxes in some states, a situation shared with corporations but not with the various forms of partnership.⁴³

These disadvantages do not seem to overly deter investors, as the popularity of LLCs continues to soar. Recent data on new formations and active entities in Delaware, for instance, show a clear lead for LLCs. LLCs constituted more than 65 percent of new entities formed in the state in 2008, with 82,680 new filings compared to 27,906 for business and

CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 52 (Thompson-West, 10th ed., 2007) (1976); see also Kelly L. Jones, *Law Firms as Limited Liability Partnerships: Determining the Scope of the Liability Shield: A Shield of Steel or Silk?* 7 Duq. Bus. L.J. 21, 25 (2005) (“Despite the existence of a full shield, the strength and thickness of that shield remains unsettled; in other words, is the shield one of steel or one of silk?”).

38. See Robert W. Hamilton, *Entity Proliferation*, 37 SUFFOLK U. L. REV. 859, 863 n.6 (2004) (summarizing the evolution of partnership liability in LLPs).

39. SMITH & WILLIAMS, *supra* note 29, at 117 (discussing the LLP form generally).

40. *Id.*

41. See ALVIN L. ARNOLD, REAL ESTATE INVESTORS DESKBOOK § 3:37 (3d ed. 2009) (stating that “the short existence of the LLC as an entity means very few court decisions have been rendered. Thus, a good deal of uncertainty exists as to the legal status of the LLC and its members”); Michael K. Molitor, *Eat Your Vegetables (Or At Least Understand Why You Should): Can Better Warning and Education of Prospective Minority Owners Reduce Oppression in Closely-Held Businesses?* 14 FORDHAM J. CORP. & FIN. L. 491, 504 (2009) (“In fact, one advantage of the LLP over the LLC is that it comes with a ‘built in’ body of case law developed over decades in the general partnership context.”) (citation omitted).

42. See ROBERT A. RAGAZZO & DOUGLAS K. MOLL, CLOSELY HELD BUSINESS ORGANIZATIONS: CASES, MATERIALS AND PROBLEMS 986 (Thompson-West, 2006) (2006) (discussing the ease of corporate reorganization and merger between two corporations).

43. See RONALD R. CRESSWELL, ET AL., 4 TEX. PRAC. GUIDE WILLS, TRUSTS AND EST. PLAN. § 13:44 (stating that in Texas, the franchise tax applies to corporations and LLCs); ARNOLD, *supra* note 41, at § 3:37 (stating that franchise taxes are not normally payable by a partnership).

professional corporations, 7,705 for LPs, 73 for LLPs, 84 for limited liability limited partnerships (“LLLPs”), 103 for general partnerships and 2,622 for business trusts.⁴⁴ While there was a general decline in overall filings, the trend is consistent with LLC dominance in recent years. In 2006, there were 97,508 new LLC filings and 112,982 in 2007. These figures contrast sharply with the numbers for business and professional corporations (33,449 in 2006 and 34,144 in 2007), limited partnerships (9,901 in 2006 and 9,852 in 2007), limited liability partnerships (114 in 2006 and 93 in 2007), limited liability limited partnerships (139 in 2006 and 84 in 2007), general partnerships (161 in 2006 and 161 in 2007) and business trusts (3,904 in 2006 and 4,478 in 2007).⁴⁵

The wide use of the LLC raises the possibility that many organizers will not fully comply with statutory requirements, thereby exposing themselves and subsequent investors in the business to personal liability. Indeed, the problem of a lack of complete compliance with the statutory requirements for organizing a business has found its way already into the LLC arena and is only likely to escalate as the popularity of the LLC continues to grow. The next part discusses how this issue has been treated in the context of other business forms.

III. THE DE FACTO AND ESTOPPEL CONCEPTS IN OTHER BUSINESS FORMS

The courts have long wrestled with the problem of defective organization.⁴⁶ Torn between enforcing the clear requirements of the statute and ensuring that justice is done, the courts appear to be propelled by a desire to do justice between the parties. The tendency to elevate substance over form by choosing to give effect to the statutory purpose instead of quibbling over technical details is not peculiar to business law. Other aspects of the law have devised similar instruments, such as the “substantial compliance” doctrine in estate planning that employs a “harmless error standard” to excuse will deficiencies and give effect to the intentions of the testator even when a will has not complied with the highly

44. International Association of Commercial Administrators: Business Organization Section, 2008 Annual Report of Delaware (2008), <http://www.gavinm.com/iaca/?country=USA&state=DE§ion=BOS&print=true> (last visited August 11, 2009).

45. *Id.* See also INTERNATIONAL ASSOCIATION OF COMMERCIAL ADMINISTRATORS: BUSINESS ORGANIZATION SECTION, 2007 ANNUAL REPORT OF DELAWARE, http://www.iaca.org/downloads/AnnualReports/2007_IACA_AR.pdf (last visited August 12, 2009) (surveying business forms filed in various jurisdictions).

46. For instance, by the early 1900s, the de facto corporation doctrine had become a well established part of American law. See Levinsohn, *supra* note 21, at 271 (discussing the de facto corporate doctrine).

technical details of the Wills statutes.⁴⁷ This part discusses devices deployed in various business forms for ensuring justice and protecting contractual expectations.

A. Corporation

In response to defective incorporation and its attendant consequences, the common law devised the concepts of de facto corporation and corporation by estoppel.⁴⁸ Where the owners of a business failed to comply with the fairly onerous requirements of incorporation, they automatically were unable to avail themselves of the primary benefit of incorporation, to wit, limited liability. The courts introduced the de facto and estoppel concepts to rescue the organizers from such a predicament. Although a defensible case could be made for according such protection, strong objections to its continuation emerged over time, especially as the incorporation process became more streamlined. This led to the abolition of the doctrines of de facto corporations and corporations by estoppel in some states.⁴⁹

It is sometimes difficult to separate the concepts of de facto corporation and corporation by estoppel.⁵⁰ The confusion associated with the distinction has led to the observation that there is simply “one unitary

47. See generally Joseph Karl Grant, *Shattering and Moving Beyond the Gutenberg Paradigm: The Dawn of the Electronic Will*, 42 U. MICH. J.L. REFORM 105, 121 (2008) (discussing the substantial compliance doctrine); John H. Langbein, *Substantial Compliance with the Wills Act*, 88 HARV. L. REV. 489 (1975) (discussing the doctrine of substantial compliance under the Wills Act); Bruce H. Mann, *Formalities and Formalism in the Uniform Probate Code*, 142 U. PA. L. REV. 1033 (1994) (analyzing the development of curative doctrines under the Uniform Probate Code); C. Douglas Miller, *Will Formality, Judicial Formalism, and Legislative Reform: An Examination of the New Uniform Probate Code “Harmless Error” Rule and the Movement Toward Amorphism*, 43 FLA. L. REV. 167 (1991) (examining the same).

48. See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 22 (Foundation Press 2008) (discussing the development of the concept of de facto corporations and corporations by estoppel).

49. See, e.g., *Sherwood & Roberts-Oregon, Inc. v. Alexander*, 525 P.2d 135, 137 (Or. 1974) (holding that a corporation cannot be formed without the issuance of a certificate of incorporation under the relevant Oregon state statute).

50. As one commentator concluded after a review and analysis of a sizeable number of cases:

[O]ne should not view the cases as falling into the two traditional boxes, de facto corporation and corporation by estoppel Evaluated by what they do, not by what they say, judges apply one unitary doctrine—that of defective incorporation The apparent confusion shown by many judges in distinguishing the two doctrines reflects the fact that they are really not two doctrines at all.

Fred S. McChesney, *Doctrinal Analysis and Statistical Modeling in Law: The Case of Defective Incorporation*, 71 WASH. U.L.Q. 493, 530-31 (1993).

doctrine . . . of defective incorporation” instead of two separate doctrines of de facto and estoppel.⁵¹ Nevertheless, this part approaches the discussion separately for purposes of clarity and because there is sufficient distinction between the two doctrines to merit the separate treatment.⁵²

1. De Facto Corporation

A corporation that has complied with the mandatory requirements of incorporation is a de jure corporation.⁵³ Such a corporation’s existence cannot be challenged by the state or any other entity or person.⁵⁴ Where a valid corporation has not been formed due to technical defect in the process of incorporation the business may be treated as a de facto corporation, provided certain requirements are met.⁵⁵ Thus, “a *de facto* corporation may be defined as an association of individuals who may have made a *bona fide* and colorable attempt to secure a charter and organize a corporation under an enabling act, and who actually assume the use of corporate powers.”⁵⁶ The existence of a de facto corporation may only be challenged by the state in a *quo warranto* proceeding.⁵⁷

51. *Id.* at 530.

52. *See, e.g.*, *Boslow Family Limited Partnership v. Glickenhau & Co.*, 7 N.Y.3d 664, 668 (N.Y. 2006) (“The doctrine of estoppel is not the same as that of de facto corporation, a doctrine that requires a party to show that it made a colorable attempt to comply with the statutes governing incorporation.”); *Pharmaceutical Sales & Consulting Corp. v. J.W.S. Delavau Co.*, 59 F. Supp. 2d 398, 405 (D.N.J. 1999) (“The doctrines of de facto incorporation and corporation by estoppel are two related but distinct concepts.”).

53. *See Robertson v. Levy*, 197 A.2d 443, 445 (D.C. 1964) (stating that “a de jure corporation results when there has been conformity with the mandatory conditions precedent (as opposed to merely directive conditions established by the statute)”; *People v. Stockton & V.R.R.*, 45 Cal. 306, 307-08 (Cal. 1873) (holding that a corporate defendant’s corporate existence cannot be challenged where the defendant substantially complied with the relevant incorporation laws). De jure status is possible even when all the requirements have not been met, provided the omitted requirement is directory, not mandatory, or the mistake is insubstantial. An example of an insubstantial mistake is a mistake in the address of an incorporator. *See, e.g.*, *People v. Ford*, 128 N.E. 479, 481 (Ill. 1920) (holding that the requirement of a seal on certificate of incorporation was directory, rather than mandatory; therefore, since the certificate complied with state law in all other respects, a de jure corporation was formed); *In re Spring Valley Water Works*, 17 Cal. 132, 132 (Cal. 1860) (holding that the failure to describe a corporation’s place of business in the articles of incorporation is a technical error that does not render the corporation invalid).

54. *See Ethanair Corp. v. Thompson*, 561 N.W. 2d 225, 229 (Neb. 1997) (stating that a third party cannot attack the legal existence of a de facto corporation).

55. *See Beavers v. Recreation Ass’n of Lake Shore Estates, Inc.*, 130 S.W.3d 702, 711-12 (Mo. Ct. App. 2004) (stating the requirements for recognition of de facto corporations); *Cantor v. Sunshine Greenery, Inc.*, 398 A.2d 571, 573 (N.J. Super. Ct. App. Div. 1979) (discussing the same).

56. Thomas H. Breeze, *The Liability of the Associates in a Defective Corporation*, 16 YALE L.J. 1, 4 (1906).

57. *See DiFrancesco v. Kennedy*, 160 A. 72, 74 (Conn. 1932) (“A de facto corporation .

Generally, based on the requisites outlined by the U.S. Supreme Court,⁵⁸ courts will treat a business as a de facto corporation if it satisfies a three-part test: (1) the existence of a statute permitting incorporation; (2) colorable compliance with the statute's incorporation provisions; and (3) actual use or exercise of corporate powers and privileges.⁵⁹ The rationale for recognizing de facto corporations is that a contrary position may sometimes defeat the contractual intent of the parties and lead to a situation where a party to a contract with the purported corporation would receive benefits beyond that for which he had bargained, i.e. a windfall.⁶⁰ In addition, "[t]he recognition of a de facto corporation is based on the principle that the state, which alone has the power to incorporate, may waive irregularities in the organization of corporations, and so long as the state remains inactive as to that issue others must acquiesce."⁶¹ The de facto doctrine is also rationalized on the ground that "[t]he state, by authorizing the corporate form, has recognized the economic advantages of limited liability"⁶² which should not be lightly extinguished on the ground of minor technicalities.⁶³

The de facto corporation doctrine became the object of severe strictures over the years.⁶⁴ One of the major problems with the concept is

. . . is an association which actually exists for all practical purposes as a corporate body, but which, because of failure to comply with some provision of the law, has no legal right to corporate existence as against a direct attack by the State."); Breeze, *supra* note 56, at 3 ("If the proceedings have been such that a *de facto*, but not a *de jure* corporation has been organized, the associates will be considered as shareholders and the incorporation can be questioned only by the state in *quo warranto* proceedings.") (citation omitted).

58. See *Tulane Irrigation District v. Shepard*, 185 U.S. 1, 13 (1902) (setting forth three requirements that constitute a de facto corporation).

59. See *Lichtenstein v. Consolidated Services Group, Inc.*, 978 F. Supp. 1, 14 (1st Cir. 1997) (stating the three requirements for de facto corporations); *Fleischauer v. Feltner*, 879 F.2d 1290, 1299 (6th Cir. 1989) (stating the same); *Matter of S & T Terry Contractors, Inc.*, 6 B.R. 84, 85 (Bankr. N.D. Ill. W. Div., 1980) (stating the same); *Rockaway Imp., LLC v. Danco Transmission Corp.*, 801 N.Y.S.2d 138, 216 (N.Y. City. Civ. Ct. 2005) (stating the same); *Application of Riverton Water Co., Inc.*, 932 P.2d 452, 500 (Kan. Ct. App. 1997) (stating the same).

60. BAINBRIDGE, *supra* note 48, at 23-24 (discussing the concept of de facto corporations).

61. 18 C.J.S. De facto Existence § 91 (citation omitted). See also Richard R. Daily, Note, *Corporations – De Facto Existence – Necessity of Good Faith Attempt to Incorporate Under and of Colorable Compliance with Incorporation Statute*, 53 MICH. L. REV. 283, 284 (1954) (stating that "if any rights and franchises have been usurped they are rights and franchises of the state, and the state alone can object").

62. BISHOP & KLEINBERGER, *supra* note 16, ¶ 6.02[2][d][i].

63. *Id.*

64. HAMILTON & MACEY, *supra* note 37, at 251 ("The common law *de facto* doctrine, as applied by courts, in particular, has been the subject of much academic analysis and criticism."). *Robertson v. Levy*, 197 A.2d 443, 445 (D.C. 1964) ("[T]he concept of de facto corporation has been roundly criticized."). See also *Swindel v. Kelly*, 499 P.2d 291, 299 n.28 (Alaska 1972) ("The concept of de facto corporations has been increasingly disfavored

that there is no clear definition of what constitutes colorable compliance.⁶⁵ Some courts may insist on stricter requirements than others.⁶⁶ For instance, it is not entirely strange to find a court recognizing the existence of a de facto corporation even though there has been a failure to file articles of incorporation.⁶⁷ More than a half-century ago, Alexander Hamilton Frey undertook an extensive study of the subject.⁶⁸ Apparently concerned that the courts were misusing the de facto doctrine, he derided the concept as “just so much jargon” that “ought to be abandoned,” adding that it was “legal conceptualism at its worst” that would be made a relic of history by modern corporation legislation.⁶⁹ Frey’s conclusions have been heavily criticized by later scholars, both on methodological and substantive grounds.⁷⁰ In particular, Professor Norwood Beveridge criticized Frey for not according enough recognition to the fact that “whether the defendants had taken reasonable steps to incorporate and reasonably believed they were incorporated” was a critical factor in a court’s decision whether to impose personal liability.⁷¹ Most significantly, Frey’s prediction of the de facto doctrine’s demise has largely gone unfulfilled.

2. Corporation By Estoppel

As mentioned in the previous section, the de facto corporation doctrine may only be invoked upon the satisfaction of certain conditions.⁷² Where the requirements have not been met, the corporation by estoppel doctrine provides business owners with another channel for escaping personal liability for debts and obligations or preventing the other party from avoiding her obligations under the contract.⁷³ Courts have opined that “the estoppel theory . . . may be invoked even when there is no corporation

. . .”).

65. See Levinsohn, *supra* note 21, at 289 (“What constitutes a colorable corporate organization is not easy to determine.”).

66. Franklin A. Gevurtz, Corporation Law § 1.4.3(a) (2000).

67. See *Bankers Trust Co. of W. N.Y. v. Zecher*, 426 N.Y.S.2d 960 (N.Y. Sup. Ct. 1980) (holding that notwithstanding that the corporation entered into an equipment security agreement with lender prior to filing its certificate of incorporation with the Secretary of State, the corporation would be deemed a de facto corporation as of the date of the agreement).

68. Alexander Hamilton Frey, *Legal Analysis and the “De Facto” Doctrine*, 100 U. PA. L. REV. 1153 (1952).

69. *Id.* at 1178, 1180.

70. *E.g.*, Bradley, *supra* note 8; McChesney, *supra* note 50.

71. Beveridge, *supra* note 22, at 963.

72. *Supra* note 60 and accompanying text.

73. See E. Merrick Dodd, *Partnership Liability of Stockholders in Defective Corporations*, 40 HARV. L. REV. 521, 536 (1927) (“Even though these requisites do not exist, most courts will, to some extent, treat the group as an entity as between parties who have acted on the assumption that there is a corporation.”).

de facto.”⁷⁴ In *Cranson v. IBM*,⁷⁵ the certificate of incorporation, although signed and acknowledged, was not filed due to the defendant’s lawyer’s inadvertence. The defendant operated on the information passed on by the lawyer that the corporation was in fact properly formed. The court held the party that recognized the entity as a valid corporation was estopped to deny the incorporation.⁷⁶ Professor Stephen Bainbridge explains that there is a basic difference between the corporation by estoppel doctrine and the familiar concept of equitable estoppel. Unlike the latter, the concept of corporation by estoppel does not require a misrepresentation, reasonable reliance, or change in position.⁷⁷ “Instead, someone who deals with the firm as though it were a corporation is estopped later to deny the corporation’s existence.”⁷⁸

Professors Robert Ragazzo and Douglas Moll have posited that part of the confusion with the corporation by estoppel concept is that it is not really one doctrine but a short hand for describing three separate doctrines.⁷⁹ One aspect of the doctrine lays out the rule that a corporation may not rely on defective incorporation to avoid a contract.⁸⁰ The scholars note that this aspect “involves a true estoppel: those purporting to act for the corporation have represented to a third party that the corporation has been lawfully formed; the third party changes his position based upon this representation; and the corporation is not able to deny its corporate status at a later time.”⁸¹ The second branch of the doctrine postulates that a third party cannot validly anchor avoidance of a contract with a purported corporation on the fact that the business was defectively incorporated.⁸² “This branch of the doctrine is actually a principle of corporate law rather than an application of traditional estoppel doctrine.”⁸³ Finally, under the third aspect, which is also a principle of corporate law rather than traditional estoppel doctrine, shareholders of a defective corporation are

74. *Cranson v. IBM*, 200 A.2d 33 (Md. 1964).

75. *Id.*

76. *Id.*

77. BAINBRIDGE, *supra* note 48, at 24.

78. *Id.* at 54; *see also* *Timberline Equip. Co. v. Davenport*, 514 P.2d 1109, 1111-1112 (Or. 1973) (“The so-called estoppel that arises to deny corporate capacity does not depend on the presence of the technical elements of equitable estoppel, viz., misrepresentations and change of position in reliance thereon, but on the nature of the relations contemplated, that one who has recognized the organization as a corporation in business dealings should not be allowed to quibble or raise immaterial issues on matters which do not concern him in the slightest degree or affect his substantial rights.” (quoting BALLANTINE, *MANUAL OF CORPORATION LAW AND PRACTICE*, §§ 28-30 (1930))).

79. RAGAZZO & MOLL, *supra* note 42, at 291.

80. *Id.*

81. *Id.* at 291.

82. *Id.*

83. *Id.* at 292.

allowed to enjoy limited liability when a third party understood her contract to be with a purported corporation.⁸⁴ The rationale for the second and third aspects is that “[w]hen a third party looks to a corporate entity as the sole obligor on a contract, he receives that for which he bargained when only the corporation is liable.”⁸⁵

Part of the justification for the doctrine is that to treat the parties otherwise would amount to imposing on them a contractual obligation that neither of them intended should be assumed.⁸⁶ In applying the doctrine, the courts are ensuring that the parties only get that to which they are entitled under their contract.⁸⁷ As Professor Edward Warren has noted, where business associates present themselves as a corporation and a third party decides to deal with them as such, the third party’s consent to the contract is also consent to “avail himself on a breach of contract of only such remedies as could be used if the associates possessed the corporate privilege.”⁸⁸ The contrary position not only defeats the parties’ intentions and expectations, but seems to encourage bad faith. Contrariwise, “[t]he immunity of the associates is founded upon good faith and upon estoppel of those who deal on the basis of one situation to maintain another for the purpose of enforcing demands to which they did not believe themselves entitled.”⁸⁹ Accordingly, since there has been a meeting of minds, as contract lawyers use that term, on the proposition to limit liability it makes ample sense for the courts to enforce the parties’ implied stipulation.⁹⁰

The corporation by estoppel doctrine is broader than the de facto corporation doctrine when viewed from the perspective that it provides limited liability protection even though no effort had been made to incorporate. But it is also narrower than the de facto corporation doctrine, because, unlike the de facto concept, investors are not able to take advantage of it if they incur tort or non-contractual obligations since the victims could not have dealt with the business believing it was a

84. *Id.*

85. *Id.* at 292.

86. See Charles E. Carpenter, *Are The Members of a Defectively Organized Corporation Liable as Partners?*, 8 MINN. L. REV. 409, 421 (1924) (arguing that intent to enter into a contract with a corporation demonstrates there was not intent to create individual liability).

87. Edward H. Warren, *Collateral Attack on Incorporation*, 20 HARV. L. REV. 456, 475-76 (1907) [hereinafter Warren I].

88. *Id.* See also Edward H. Warren, *Collateral Attack on Incorporation*, 21 HARV. L. REV. 305, 313 (1908) [hereinafter Warren II] (“So, it may be urged, when A consents to deal with the associates as a corporation, he should not be allowed thereafter to take another position logically inconsistent [i.e., denying that they are a corporation]. There is force in that argument.”) (clarification added).

89. Levinsohn, *supra* note 21, at 284 (citing *Slocum v. Head*, 81 N.W. 673 (Wis. 1900)).

90. *Id.* at 285.

corporation.⁹¹ Like the de facto corporation doctrine, the corporation by estoppel doctrine has also been subject to immense and intense criticism.⁹² For instance, it is criticized for permitting those who have made untrue representations about corporate existence to escape personal liability.⁹³

3. The Model Corporations Act

The 1950 Model Business Corporation Act (MBCA) sought to whittle the effect of the doctrine of de facto corporation.⁹⁴ The 1969 Model Act retained the text of the 1950 and 1960 revisions in stating that the certificate of incorporation shall be “conclusive evidence” of incorporation except as against the state and that all persons assuming to act as a corporation without authority would be jointly and severally liable for all the debts of the business.⁹⁵ However, while the earlier official comments were at best tentative, the comments to the 1969 act unequivocally stated that “a de facto corporation cannot exist under the Model Act.”⁹⁶ It took several decades for critics to acknowledge that efforts to abolish the de facto corporation and corporation by estoppel doctrines had failed.⁹⁷ Indeed, the predicted demise of the doctrines turned out to be clearly exaggerated.⁹⁸ The Official Comment to the 1984 MBCA § 2.04 provides a helpful catalog of the odyssey of the defective incorporation doctrines through near-death and ultimate resurrection. The Comment states in relevant parts as follows:

A review of recent case law indicates . . . that even in states with . . . [statutes that impose personal liabilities for preincorporation transactions or obligations], courts have continued to rely on common law concepts of de facto corporations, de jure corporations, and corporations by estoppel that provide uncertain protection against liability for preincorporation transactions.

91. RAGAZZO & MOLL, *supra* note 42, at 292.

92. *E.g.*, Bradley, *supra* note 8.

93. *See* GEVURTZ, *supra* note 66, at §1.4.3(b). The criticism is well-noted but if the other party was content to deal with the entity as a limited liability entity, it may not necessarily be a fair outcome to allow it to receive more than what their bargain contemplated.

94. *See* Beveridge, *supra* note 22, at 966 (describing the act, and accompanying comments, which suggested there could be no de facto corporation before the issuance of the certificate of incorporation).

95. MODEL BUS. CORP. ACT §§ 56, 146 (1969).

96. 1 MODEL BUS. CORP. ACT ANN. § 2.04, historical background at 2-50 (3d ed. Supp. 2000-2002) (emphasis omitted).

97. *See* Bradley, *supra* note 8, at 533-36 (explaining changes to the Model Act and comments and describing reactions to these changes).

98. *See* Douglas C. Michael, *To Know a Veil*, 26 J. CORP. L. 41, 47 (2000) (noting that Professor Frey’s prediction had not materialized).

These cases caused a review of the underlying policies represented in earlier versions of the Model Act and the adoption of a slightly more flexible or relaxed standard. Incorporation under modern statutes is so simple and inexpensive that a strong argument may be made that nothing short of filing articles of incorporation should create the privilege of limited liability. A number of situations have arisen, however, in which the protection of limited liability arguably should be recognized even though the simple incorporation process established by modern statutes has not been completed.⁹⁹

The Comment proceeds to outline some of these exceptions, three of which are germane to this article. They include a situation where (1) incorporation documents have not been filed due to attorney neglect or other cause but a corporate organizer reasonably and honestly believing they have been filed, enters into a transaction in the name of the corporation; (2) transactions entered into after the mailing of incorporation documents or their delivery to the filing office but they have not been received in the filing office due to no fault of the filer; and (3) cases where passive investors provide funds to the corporate promoter with express instructions that the funds should not be utilized prior to incorporation.¹⁰⁰

The crucial point about the 1984 revision of the MBCA is that, unlike previous incarnations of the model statute, it did not seek to abolish *de facto* corporation outright or question its applicability. It allows sufficient room for the *de facto* and estoppel doctrines to operate through § 2.04, which provides that “[a]ll persons purporting to act as or on behalf of a corporation knowing that there was no incorporation under this Act, are jointly and severally liable for all liabilities while so acting.”¹⁰¹ In fact, so wide is the latitude for the operation of the doctrines that one scholar has remarked that the 1984 MBCA has “return[ed] the situation for all practical purposes to where it was in 1950” and therefore “[t]he comment should explicitly acknowledge that the doctrines of *de facto* corporations and corporations by estoppel are no longer abolished in Model Act states.”¹⁰² While this sentiment is not universally shared, with some commentators willing to concede that the doctrines probably have been restored but not with the same force as before the Model Act, there is hardly any question about the survival of the doctrines under the current formulation of

99. 1 MODEL BUS. CORP. ACT ANN. § 2.04, official cmt. at 2-46 (3d ed. Supp. 1997).

100. *Id.* at 2-46. The other enumerated instances are where “the third person has urged immediate execution of the contract in the corporate name even though he knows that the other party has not taken steps toward incorporating” and where the “third person has dealt only with the ‘corporation’ and has not relied on the personal assets of the defendant.” *Id.*, at 2-47.

101. Model Bus. Corp. Act § 2.04 (1984).

102. Beveridge, *supra* note 22, at 971.

MBCA.¹⁰³

Borrowing from that, one can also safely interpret similarly worded or similar-purpose LLC statutes as also permissive of the application of the de facto and estoppel doctrines to LLCs. In the same vein, LLC statutes that import the pre-1984 formulation of the purporting-to-act provision can also be construed as restricting or rejecting the application of the doctrines.

B. *General Partnership*

Partnership by estoppel has been described as “one of the danger areas for small businesses and requires special vigilance.”¹⁰⁴ Drawing on the English Partnership Act of 1890, the Uniform Partnership Act of 1914 codified the doctrine, a step that has been continued by the Revised Uniform Partnership Act of 1997, albeit under the different title of “purported partnership.”¹⁰⁵ A person or firm may be held liable as a partner or partnership even though no partnership in fact existed or, in the case of an existing partnership, another person is held out as a partner in the firm.¹⁰⁶ Representation and reasonable reliance are at the core of the partnership by estoppel concept.¹⁰⁷ Thus, liability arises where a would-be partner directly holds himself out as a partner or is so held out by others with his consent, and a creditor who has knowledge of the holding out justifiably and detrimentally relies on the ostensible partnership by extending credit upon its faith.¹⁰⁸

103. See e.g., Darst, *supra* note 6, at 321-23 (discussing common law defenses).

104. Robert B. Macaulay, *Florida Small Business Practice*, §5.5 (2004).

105. Howard P. Walthall, Sr., *What Do You Mean “We,” Kemo Sabe?: Partnership Law and Client Responsibilities of Office Sharing Lawyers*, 28 CUMB. L. REV. 601, 629-30 (1998).

106. E.g., *Gosselin v. Webb*, 242 F.3d 412 (1st Cir. 2001); Justin Elrod, *Annual Survey of Caselaw*, 26 U. ARK. LITTLE ROCK L. REV. 805, 811-12 (2004); John W. Marshall, *Partnership by Estoppel – Liability by Surprise*, 46 B. B. J. 6, 6 (2002). See also George M. Cohen, *The Multilayered Problems of Professional Responsibility*, 2003 U. ILL. L. REV. 1409, 1443 (“Under the doctrine of partnership by estoppel, however, lawyers who are not in fact partners may be held vicariously liable for each other’s malpractice if they hold themselves out to the public as partners . . .”).

107. See Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 1000 n.407 (2006) (“[P]artnership by estoppel under substantive law requires reliance upon a representation.”); Jones, *supra* note 37, at 36 (2005) (emphasizing the reasonableness component).

108. REVISED UNIF. P’SHIP ACT § 308 (1997); UNIF. P’SHIP ACT § 16 (1914); *Brown v. Gerstein*, 460 N.E.2d 1043 (Mass. App. Ct. 1984), *cert. denied*, 464 N.E.2d 73 (Mass. 1984); David A. Barry & William L. Boesch, *Legal Malpractice Law in Massachusetts: Developments 1993-2000*, 85 MASS. L. REV. 2, 21 (2000); Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel as Well as Full General Partner Liability?*, 37 SUFFOLK U. L. REV. 667, 702 (2004).

In one case, two lawyers had openly referred to themselves as “partners” and listed themselves as such on their letterhead.¹⁰⁹ One of the lawyers misappropriated a client’s funds. The court held that the lawyer who had not participated in the misappropriation was nonetheless jointly and severally liable for the torts of the misappropriating lawyer. The court reasoned that since the lawyers had represented that they were partners in fact, upon which representation the client had relied, the nonparticipating lawyer was estopped to deny the existence of a partnership.¹¹⁰

A partnership by estoppel could also be “created” where a general partnership upon electing LLP status, omits to conform with the requirements relating to designation as an LLP in relevant business documents and professional listings.¹¹¹ In such a situation, “a creditor could invoke purported partner liability by arguing that he reasonably relied on the partner’s representations and thus understood the business to be a general partnership instead of a LLP.”¹¹²

The basis of the partnership by estoppel concept is justice to third parties whose interests would otherwise be jeopardized as a result of their reliance on the false representation that a partnership exists.¹¹³ As one commentator has noted, “the very point of the doctrine of partnership by estoppel is to impose liability when equity so demands, but the elements of a true partnership are not present.”¹¹⁴ Thus, without the application of the partnership by estoppel doctrine, those who have made misrepresentations as to partnership status or consented to such representations may be able to escape liability, taking refuge in technical legal rules. Accordingly, the doctrine steps in “to prevent a party from hiding behind a technical rule of law when equity dictates that he or she be held to the legal consequences of

109. Myers v. Aragona, 318 A.2d 263 (Md. Ct. Spec. App. 1974).

110. *Id.*

111. Jones, *supra* note 37, at 36.

112. *Id.* at 36 (citation omitted). See also Gregory Huffman, *Creating the Legal Monster: The Expansion and Effect of Legal Malpractice Liability in North Carolina*, 18 CAMPBELL L. REV. 121, 152 (1996) (“[A] limited liability partnership could become a partnership by estoppel . . . where the LLP or its partners hold themselves out as a normal partnership in some manner to a third party.”).

113. John W. Gergacz, *A Proposal for Protecting Executive Communications with Corporate Counsel After the Corporate Client Has Waived its Attorney-Client Privilege*, 13 FORDHAM J. CORP. & FIN. L. 35, 58 (2008) (“No organizational form is created when third parties rely on false representations that a partnership exists. Instead, liability is imposed, as if a partnership exists, to ameliorate the unfairness arising from the relying party’s otherwise unsatisfied claims. Without partnership by estoppel, the logic of partnership law has it that ersatz partners would not face liability. They were not parties by contract, personally, nor were they operating a business as a partnership. For justice reasons, the party’s interests needed to be accommodated.”) (citation omitted).

114. Edward L. Fenasci, *Butler v. Atwood and Gravois v. New England Insurance Co.: Enigmas in Louisiana’s Law of Partnership by Estoppel*, 46 LOY. L. REV. 353, 355 (2000).

his or her representations. . . .”¹¹⁵

C. *Limited Partnership*

1. De Facto Limited Partnership

Early LP statutes and many judicial opinions in the United States recognized limited liability status of limited partners only where there had been strict compliance with the statutory provisions.¹¹⁶ “Thus, slight technical omissions in either the execution or filing of the certificate of limited partnership gave rise to unlimited personal liability for all partners, including persons who attempted to establish themselves as and believed themselves to be limited partners.”¹¹⁷ The strict statutory construction made it risky to participate in business as limited partners, generating a reluctance to invest in this business form.¹¹⁸ As a result, many business enterprises that would have found the LP to be most suitable to their needs were constrained to abandon that course of action and choose the less than optimal option of incorporation.¹¹⁹

The codification and various revisions of the LP statute have sought to alleviate the hardship on limited partners and provide them greater protection from personal liability, even when they have not met all the legal requirements for operating as LPs. The Uniform Limited Partnership Act (ULPA) of 1916 permitted limited liability status where there has been “substantial compliance” with the filing requirements.¹²⁰ The courts came up with two main approaches to interpreting the statutory provision. Some courts equated substantial compliance with attempted satisfaction of the basic statutory requirement, namely filing of certificate of formation.¹²¹ Thus, if efforts were made to comply with the filing requirements but fell short in some minor detail, the court treated the entity as a limited partnership and thereby shielded the limited partners from personal liability.¹²² Other courts viewed the provision from the prism of the

115. *Id.* at 361.

116. R. Kurt Wilke, *Limited Partnership Control: A Reexamination of Creditor Reliance*, 60 IND. L.J. 515, 517 (1985).

117. J. William Callison & Maureen A. Sullivan, *Partnership Law and Practice: General and Limited Partnerships*, § 19.3 (2008) [hereinafter Callison & Sullivan, *Partnership Law*].

118. *Id.*

119. *Id.*

120. *Id.* See also THE UNIFORM LIMITED PARTNERSHIP ACT, § 2(2) (1916) (providing that “a limited partnership is formed if there has been substantial compliance in good faith with the filing requirements of [§ 2(1)]”).

121. See CALLISON & SULLIVAN, *PARTNERSHIP LAW*, *supra* note 117, at § 19.3 (discussing the doctrine of substantial compliance).

122. *Id.*

purpose it sought to accomplish to wit, protection of third parties by giving them notice of the nature of the business with which they were transacting. Accordingly, where a third party creditor has notice that the business is an LP, the limited partners are not personally bound for any contractual obligations arising from the transaction.¹²³

Under the Revised Uniform Limited Partnership Act (RULPA) of 1985, which has been adopted by most states,¹²⁴ the filing of a certificate of limited partnership is a condition precedent to the formation of a limited partnership.¹²⁵ However, if no certificate is filed or a filed certificate is not in substantial compliance with the statutory requirements,¹²⁶ limited partners are nevertheless provided with substantial protection if they acted under the mistaken belief that they were indeed limited partners.¹²⁷ First, a limited partner in a defectively formed LP is liable only to a third party who believed in good faith that the limited partner was a general partner at the time of the transaction.¹²⁸ With regard to future transactions, persons operating under the mistaken belief that they are limited partners may avoid personal liability if they cause a certificate of limited partnership or an amendment to the certificate to be filed or withdraw from future equity participation.¹²⁹

De facto LPs not only arise in the context of initial or amended filings but also in cases of certificate renewal. Thus, where a creditor sought to hold partners personally liable for merchandise he had sold to the firm, claiming that since the LP had failed to secure the renewal of its certificate of authority from the secretary of state, it had transformed into a general partnership at the time the goods were sold, the Florida District Court of Appeal disagreed.¹³⁰ Analogizing to a de facto corporation, the court held that the firm, upon failing to maintain its de jure status, became a de facto

123. *Id.*; cf. *Gamma Farms v. United States*, No. C-89-20688-RFP, 1990 WL 107421, at *5 (N.D. Cal. June 22, 1990) (holding that the notice argument was inapplicable under California law).

124. ALVIN L. ARNOLD & MYRON KOVE, *REAL ESTATE PROFESSIONAL'S TAX GUIDE* § 37:1 (May 2009); Thomas E. Rutledge, *To Boldly Go Where You Have Not Been Told You May Go: LLCs, LLPS, and LLLPS in Interstate Transactions*, 58 *BAYLOR L. REV.* 205, 222 (2006).

125. *Reformed Uniform Limited Partnership Act* § 201(b) (1976) (hereinafter "RULPA").

126. *See* RULPA § 201(a) (setting forth the statutory requirements for filing a certificate of limited partnership).

127. *See* RULPA § 304 (discussing the protections provided for individuals who erroneously believe they are a limited partner).

128. *Id.*

129. *Id.* For a good discussion of this provision in a judicial opinion, *see* *Briargate Condo. Ass'n v. Carpenter*, 976 F.2d 868, 870-71 & n.6 (4th Cir. 1992) (discussing the potential liability of a woman who was deceived into investing funds into what she thought was a limited partnership when in fact the entity was a general partnership).

130. *Vulcan Furniture Mfg. Corp. v. Vaughn*, 168 So.2d 760 (Fla. Dist. Ct. App. 1964).

LP.¹³¹ Accordingly, the limited partner retained his limited liability status. Explaining the basis of its decision, the court noted that the statutory purpose did not contemplate that a contributor of capital, who did not participate in the detailed operation of the business nor induce creditors to extend credit on the belief that the investor was a general partner, would be personally bound for the partnership's obligations where "creditors had no reason to believe at the times their credits were extended that such person was so bound."¹³²

2. Limited Partnership By Estoppel

The requirements for a limited partnership by estoppel are acts or representations by one party inducing another party to rely on the existence or acceptance of a limited partnership and reliance by the innocent party upon those acts or representations to his detriment.¹³³ In applying the LP by estoppel doctrine, the courts are favorably disposed toward an outcome that ensures justice between the parties. Accordingly, in an action brought by a purported limited partnership against its investment advisor seeking damages for breach of contract and negligence in managing funds, the court applied a "corporation by estoppel" approach in holding that regardless of the fact that the plaintiff failed to file its initial certificate of LP until after commencement of the lawsuit, the advisor was estopped to deny the validity of the plaintiff as an LP.¹³⁴ The court took cognizance of the fact that the advisor derived benefit from the agreement it entered into with the plaintiff for the provision of investment services, provided investment services to the plaintiff, and the advisor's provision of services was not dependent in any way on the plaintiff's nature as an LP.¹³⁵ Therefore, the court denied the investor an opportunity to use the lack of proper formation as a "sword to escape liability after it benefitted from its contract with plaintiff."¹³⁶

Some courts also justify the application of estoppel to protect limited

131. *Id.* at 764.

132. *Id.*

133. *See* Leventhal v. Atlantic Rainbow Painting Co., Ltd., 172 A.2d 710, 714 (N.J. Super. Ct. App. Div. 1961) (holding that the association was not a limited partnership association, de jure, de facto, or by estoppel, when the members were injured in an accident almost a year after the association's charter expired). *See also* *In re* Lloyd Securities, Inc. v. Goldstein Mgmt., Inc., 1992 WL 165962, at *8 (Bankr. E.D. Pa. 1992) (relying on the same principles to deny a claim of LP by estoppel because "the requisite innocent parties who relied on this status to their detriment are absent").

134. *Boslow Family Ltd. P'ship v. Glickenhau & Co.*, 860 N.E.2d 711, 713 (N.Y. Dec. 14, 2006).

135. *Id.*

136. *Id.*

partners in defectively formed LPs on the ground that the limited partnership act is a notice statute.¹³⁷ Thus, in a case where the appellee limited partners had admitted that they had failed to file a certificate of LP as required, one court was prompted to conclude that because the “appellants already had the information that would have been provided by compliance with the statute prior to dealing with the limited partnership, the failure to comply with [the statute’s filing requirements] does not cause appellees to lose their status as limited partners.”¹³⁸

In some states, the de facto and estoppel concepts have permeated the LLC structure, while other states have either jettisoned the doctrines altogether or have not addressed it through legislation or judicial decision. The following part first examines the legislative provisions, followed by a highlight of pertinent judicial decisions.

IV. DE FACTO LLC AND LLC BY ESTOPPEL

Following the corporate model, a de facto LLC would exist where there is (1) a statute authorizing organization as an LLC in the state, (2) colorable compliance or good faith effort to comply with the statute, and (3) actual use or exercise of the powers and privileges of an LLC.¹³⁹ An LLC by estoppel may arise where parties treat a business enterprise as a valid LLC even if no attempt at formal organization has been made.

A. Statutory Provisions

One legislative approach regarding commencement of business or incurring of obligations prior to registration of LLCs is to emphasize that there is no formation of an LLC until the filing of the articles or

137. See e.g., *Garrett v. Koepke*, 569 S.W.2d 568, 669 (Tex. Ct. App. 1978) (holding that because Texas’ limited liability statute is a notice statute and plaintiffs were provided with all of the information required by the statute prior to dealing with defendants, defendants’ status as a limited partnership does not fail despite the fact that they did not fully comply with the statute).

138. *Id.* at 579; cf. *Dwinell’s Cent. Neon v. Cosmopolitan Chinook Hotel*, 587 P.2d 191, 194 (Wash. Ct. App. 1978) (“[A] third party’s knowledge regarding the status of a limited partnership is irrelevant when at the time of contracting, the partners have made no attempt to comply with the statutory information and filing requirements of the Limited Partnership Act A creditor has the right to rely upon there being substantial compliance . . . before the protection of [the limited partnership statute’s] provisions are afforded to any member of a partnership. Here there was no compliance.”) (citations omitted).

139. Since all 50 states have LLC statutes, the first requirement is easily met. See *Wooster*, *supra* note 24, at 611 (stating that the fifty states and the District of Columbia have all enacted LLC legislation). For a discussion of the possible reasons for the speedy spread of LLC statutes to all fifty states, see Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819, 836-37 (2001) (discussing the emergence of LLC statutes).

organization or until the issuance of a certificate of organization or other document by the appropriate state official.¹⁴⁰ Some states clearly provide that, save for a few activities, notably those incidental to the LLC's organization or to obtaining subscriptions for or payment of capital contributions, LLCs may not transact business or incur debt prior to filing of the articles.¹⁴¹ Parties who choose to ignore the admonition or otherwise act contrary to it expose themselves to joint and several liability for debts and liabilities incurred while acting as an LLC when they lacked the authority to do so.¹⁴² Ten states¹⁴³ have this rigid version in one form or another.¹⁴⁴ A strict reading of such statutory provisions would negate the

140. J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, LIMITED LIABILITY COMPANIES: A STATE-BY-STATE GUIDE TO LAW AND PRACTICE § 3:2 (2009) [hereinafter CALLISON & SULLIVAN, LLCs].

141. *Id.*

142. *Id.*

143. The states are Alabama: ALA. CODE § 10-12-7 (West 2009) ("All persons who assume to act as a limited liability company without authority to do so shall be jointly and severally liable for all debts and liabilities created by their so acting."); Arizona: ARIZ. REV. STAT. ANN. § 29-652 (2010) ("All persons who assume to act as a limited liability company without authority to do so are jointly and severally liable for all debts and liabilities incurred by the persons so acting."); Missouri: MO. ANN. STAT. § 347.037.4 (West 2009) ("A limited liability company may not transact business or incur indebtedness, except that which is incidental to its organization or to obtaining subscriptions for or payment of contributions, until the articles of organization have been filed with the secretary or until the formation date specified in the articles of organization. Persons engaged in prefiling activities other than those described in the preceding sentence shall be jointly and severally liable except as provided in this section for any debts or liabilities incurred in the course of those activities."); Nebraska: NEB. REV. STAT. § 21-2635 (West 2009) ("All persons who assume to act as a limited liability company without authority to do so shall be jointly and severally liable for all debts and liabilities of the company."); Nevada: NEV. REV. STAT. ANN. § 86.361 (West 2008) ("All persons who assume to act as a limited-liability company without authority to do so are jointly and severally liable for all debts and liabilities of the company."); North Dakota: N.D. CENT. CODE § 10-32-26 (West 2009) ("All persons who assume to act as a limited liability company without authority are jointly and severally liable for all debts and liabilities incurred or arising as a result."); Rhode Island: R.I. GEN. LAWS Ann. § 7-16-71 (West 2009) ("All persons who assume to act as a limited liability company without authority to do so are jointly and severally liable for all debts and liabilities."); Utah: UTAH CODE ANN. § 48-2c-602 (West 2009) ("All persons who assume to act as a company without complying with this chapter are jointly and severally liable for all debts and liabilities so incurred, except for debts incurred in the course of prefiling activities authorized under Section 48-2c-404."); Virginia: VA. CODE ANN. § 13.1-1007 (West 2009) ("It shall be unlawful for any person to transact business in this Commonwealth as a limited liability company or to offer or advertise to transact business in this Commonwealth as a limited liability company unless the alleged limited liability company is either a domestic liability company or a foreign limited liability company authorized to transact business in this Commonwealth. Any person who violates this section shall be guilty of a Class 1 misdemeanor."); Wyoming: WYO. STAT. ANN. § 17-15-133 (West 2009) ("All persons who assume to act as a limited liability company without authority to do so shall be jointly and severally liable for all debts and liabilities.")

144. For instance, while Missouri statute forbids LLC pre-formation activities, with the

application of the de facto and estoppel concepts. As a matter of fact, some courts have already decided along those lines.¹⁴⁵ It appears that some of these states may have been influenced by Wyoming's pioneering provision,¹⁴⁶ which preceded the 1984 MBCA and might have been influenced by the pre-1984 versions of the Model Corporations Act.¹⁴⁷ With the 1984 MBCA pointing to a different direction, it may be wise to revise the various state laws in that respect. Indeed, the rigid version does not seem to represent the modern trend.¹⁴⁸

Some states have statutory provisions that refuse to impose personal liability in some instances, such as when the LLC organizers or members acted without knowledge that there was no registration or acted with a good faith belief that they had authority to act. Four states have this kind of provision.¹⁴⁹ The remaining thirty-six states and the District of Columbia

exception of those "incidental to its organization or to obtaining subscriptions for or payment of contributions," it adds that the "section shall not be interpreted to invalidate any debts, contracts, or liabilities of the limited liability company incurred solely on behalf of a limited liability company to be formed, nor shall it be interpreted to impose personal liability on the persons incurring such debts, contracts or liabilities solely on behalf of the limited liability company to the extent so disclosed or to the extent such debts, contracts or liabilities provide otherwise." MO. ANN. STAT. § 347.037.4 (West 2009). Virginia makes it a misdemeanor punishable by a prison sentence of not more than twelve months and a fine of not more than \$2,500 or both to transact business as an LLC without authority. See VA. CODE ANN. § 13.1-1007, 18.2-11 (West 2009) (noting together that those who transact or offer to transact business as a limited liability company without authorization would be guilty of a Class 1 misdemeanor, which is punishable by confinement in jail for not more than twelve months and a fine of not more than \$2,500, either or both).

145. See e.g., *Shelter Mortgage*, *infra* note 204 (interpreting the Utah statute as imposing personal liability on those who assume to act as a company before LLC is formed).

146. See Commentary to Alabama Limited Liability Company Act, ALA. CODE 1975 § 10-12-7 ("This section is similar to Wyoming's Limited Liability Company Act (§ 17-15-133).").

147. Wyoming enacted the country's first LLC statute in 1977. See WYO. STAT. ANN. 17-15-101 (West 2009) (creating the Wyoming Limited Liability Company Act in 1977).

148. RIBSTEIN & KEATINGE, *supra* note 17, at § 4.15 (noting that such statutory provisions do not reflect the more recent trend).

149. The states are Colorado: COL. REV. STAT. ANN. § 7-80-105 (West 2009) ("All persons who assume to act as a limited liability company without authority to do so and without good faith belief that they have such authority shall be jointly and severally liable for all debts and liabilities incurred by such persons so acting."); Florida: FLA. STAT. ANN. § 608.4238 (West 2010) ("All persons purporting to act as or on behalf of a limited liability company, having actual knowledge that there was no organization of a limited liability company under this chapter, are jointly and severally liable for all liabilities created while so acting except for any liability to any person who also had actual knowledge that there was no organization of a limited liability company."); Kentucky: KY. REV. STAT. ANN. § 275.095 (West 2009) ("All persons purporting to act as or on behalf of a limited liability company, knowing there has been no organization under this chapter, or who assume to act for a limited liability company without authority to do so, shall be jointly and severally liable for all liabilities created while so acting."); Oregon: OR. REV. STAT. ANN. § 63.054 (West 2009) ("All persons purporting to act as or on behalf of a limited liability company,

have maintained legislative silence on the subject.¹⁵⁰

Similarly, a number of courts have pronounced on the de facto and estoppel concepts in relation to LLCs. From the reported cases, some states clearly recognize either or both of the concepts while some take the opposite position. There does not seem to be judicial pronouncements on the issue from many other states. The remaining portions of this part survey and analyze judicial decisions on the issue, with Section B discussing cases applying either concept, Section C examining cases deciding otherwise, and Section D providing a more detailed analysis.

B. Cases Recognizing De Facto LLC or LLC By Estoppel

Various courts in numerous states have adopted varying positions in relation to pre-formation transactions and obligations pertaining to LLCs. Not surprisingly, some courts recognize the de facto doctrine where there has been colorable compliance, paralleling the recognition of de facto corporations. Holding that “the de facto corporation doctrine is equally applicable to limited liability companies,”¹⁵¹ the appellate division of the New York Supreme Court added that to establish that an entity is a de facto LLC, there must be a showing that a colorable attempt was made to comply with the statute governing the organization of LLCs.¹⁵²

Where an LLC was already in legal existence at the time of service of court process, but the dispute raged around action taken before the Secretary of State accepted the articles of organization, a Connecticut superior court took a strong stand for de facto LLCs, drawing insight from the analogous concept in corporate law.¹⁵³ The court noted that it had “not

knowing the limited liability company was not then in existence, are jointly and severally liable for all liabilities created while so acting.”)

150. See RIBSTEIN & KEATINGE, *supra* note 17, at App. 4-3 (listing the section numbers for LLC statutes in the fifty states and indicating which statutes allow for substantial compliance). While Mississippi does not have an assume-to-act provision, its statute provides that any person who is required to file a certificate and fails to do may be liable to persons adversely affected by the failure to file. MISS. CODE ANN. § 79-29-206.

151. *In Re. Hausman*, 51 A.D.3d 922, 924, 858 N.Y.S.2d 330 (N.Y.S. App. 2008).

152. *Id.* (finding that such an attempt was not made in the instant case prior to the purported acceptance of a deed by the LLC, the articles of organization having been filed with the Department of State two weeks thereafter). See also *Leber Associates, LLC v. Entertainment Group Fund, Inc.*, No. 00 Civ.3759 LTS MHD, 2003 WL 21750211 (S.D.N.Y. July 29, 2003) (evinced amenability to applying the de facto and estoppel concepts but unable to apply them because sufficient efforts, such as drawing up a certificate of formation or attempting to file such a certificate, had not been taken, to confer de facto status on the plaintiff and the record before the court raised questions of fact that precluded determination of whether the defendants should be stopped from denying that the plaintiff was a distinct legal entity).

153. *Simsbury-Avon Preservation Society, LLC v. Metacon Gun Club, Inc.*, No. CV040834190S, 37 Conn. L. Rptr. 726, 2004 WL 2094933 (Conn. Super. Ct. Aug. 20,

been advised by the parties of any reason why the same considerations [applicable to de facto corporations] ought not to apply to limited liability companies, especially where the prejudice would appear to be nil.”¹⁵⁴ It follows that where an attempt was made at formal registration, but some defect in the articles of organization prevented the formal formation of the LLC, some courts will be sympathetic to preserving contractual undertakings, reminiscent of the de facto corporation experience.¹⁵⁵

Even when there was no colorable compliance before the contract, some courts have also shown amenability to the de facto and estoppel concepts. In some of these cases, the LLC was eventually formally organized, which might have been an important factor in the decision, but lack of eventual organization has not been a complete bar to recognition. Where an LLC entered into a residential lease with the defendant on April 29, 2006 but did not file articles of organization until August 2, 2006, the court applied the rule relating to de facto corporations and corporations by estoppel to the transaction.¹⁵⁶ The court noted that based on the allegations in the case, “the defendant transacted business with [the LLC] SWEM prior to SWEM’s incorporation [sic], and, as such, the defendant should be stopped from denying SWEM’s existence.”¹⁵⁷

In another case, the creditor alleged that he extended a loan to the LLC on October 10, 1995.¹⁵⁸ The LLC organizer signed the note on behalf of the company, representing that the LLC was already in existence at the time of the loan. However, the LLC was not registered with the Florida Secretary of State until March 7, 1996.¹⁵⁹ The creditor maintained in his complaint that he did not know that the LLC had not been created at the time of the loan. Based on that, he wanted to hold the organizer personally liable for the loan but the organizer raised three affirmative defenses, based on his allegation that the creditor “knew about the company’s status when the note was delivered . . . and had participated as an agent, officer, or

2004).

154. *Id.*

155. See *Allen v. Scott, Hewitt and Mize, LLC*, 186 S.W.3d 782, 784 (Mo. Ct. App. W.D. 2006), *transfer denied*, (Feb. 28, 2006) and *transfer denied*, (Apr. 11, 2006) (considering the formation issues to be irrelevant in holding that it was “of no consequence to the [vendors] that [the organizer] assigned his interest to an entity that, because of a defect in its organizational paperwork, had not finished the organizational process,” adding that the LLC was capable of receiving a valid conveyance despite the fact that it had not completed the process of organization, and further holding that the vendors “cannot challenge the transfer on the basis that [the LLC] was not yet a *de jure* entity”).

156. *DEA & Associates, LLC v. McCall*, No. CVH-7482, 2007 WL 117487 (Conn. Super. Ct. Jan. 12, 2007).

157. *Id.* at *3.

158. *Ruggio v. Vining*, 755 So.2d 792, 793 (Fla. Dist. Ct. App. 2000).

159. *Id.*

representative of the unformed LLC in 1995 and 1996.”¹⁶⁰

In amending a previously denied motion for summary judgment, the creditor relied in part on the provision of the Florida LLC statute (since replaced) that provided that “[a]ll persons who assume to act as a limited liability company without authority to do so shall be jointly and severally liable for all debts and liabilities.”¹⁶¹ Interestingly, the loan agreement in the case predated the current version of the Florida LLC statute that, in amending the earlier version, expressly imposes personal liability only on persons with actual knowledge of the lack of organization of an LLC.¹⁶² Yet the court interpreted the earlier provision broadly and permitted the application of the notion of LLC by estoppel, despite the “statutory silence.”¹⁶³ In a later case, the U.S. Court of Appeals for the Fifth Circuit relied on this decision to hold that “Florida law permits the application of de facto corporation and corporation by estoppel to LLCs.”¹⁶⁴

In a bankruptcy proceeding, it was moved that because the debtor was never registered under the laws of the State of Connecticut, it was a non-existent entity, and therefore not a person qualified to be a debtor under Section 109(d) of the Bankruptcy Code.¹⁶⁵ The debtor conceded it had no official, or de jure, existence on the Petition Date, but argued that Connecticut law would regard the entity as a de facto LLC under the principles established for corporations.¹⁶⁶ It supported its claim with the fact that it had conducted business in good faith under the name “4 Whip LLC” mistakenly believing that formation documents had been submitted to, and approved by, the Connecticut Secretary of State.¹⁶⁷ The U.S. Bankruptcy court concluded that there was sufficient room under the Bankruptcy Code’s qualification criteria for permitting an inchoate or de facto LLC such as 4 Whip to be a debtor, and thus entitled to bankruptcy relief, so long as that entity had a bona fide business existence prior to the

160. *Id.*

161. *Id.* at 794.

162. *See infra* note 242.

163. *Ruggio v. Vining*, 755 So.2d at 795. *See also* *VGY Development, LLC v. 376 South Colony Realty Corp.*, 43 Conn. L. Rptr. 459, 2007 WL 1675090 (Conn. Super. Ct. 2007) (declining to void a contract entered into by an unformed LLC, stating that “[t]he contract was entered into on behalf of the plaintiff by a natural person who presumably had the capacity to do so, and, accordingly, the contract is not void from its inception” and further holding that once the LLC was formed under Connecticut law it had the requisite standing to bring suit).

164. *Western Securities Corporation v. Eternal Technologies Group, Inc.*, 2008 WL 5212386 (C.A.5 (Tex.) 2008).

165. *In re 4 Whip, LLC*, 332 B.R. 670, 45 Bankr. Ct. Dec. (CRR) 168 (Bankr. D. Conn. 2005).

166. *Id.* at 671.

167. *Id.*

petition date.¹⁶⁸

Some courts may also be willing to recognize de facto LLCs, and thereby provide protection from personal liability and validity to pre-formation transactions, where the organizers enter into the transactions on behalf of an LLC they did not know has not been properly organized. The flip side is that where they had such knowledge, they are likely to be held personally liable and the transaction invalidated. This result was reached in a case where a commercial landlord filed action against an LLC, as tenant, and against the LLC's members, seeking to collect use and occupancy payments for a five-month period following the expiration of a lease, and to collect damages for defendants' failure to clear, grade, pave, and fence the lot as agreed upon in the lease.¹⁶⁹ The LLC was not in existence at the time of contract and members signed the lease in their individual names, although a notary's attestation stated that they were doing business as "Fairfield County Paving & Construction, Inc."¹⁷⁰ There was no corporation by that name at that time, but an LLC in the same name was eventually duly registered. The court held that since the members entered into the contract knowing that there was no properly organized LLC, they were personally liable.¹⁷¹ This position is consistent with the provisions of MBCA § 2.04 that is acknowledged as permitting the application of the de facto and estoppel concepts.¹⁷²

Where a party accepts benefits under a contract with an unformed LLC, the lack of proper organization may not suffice to void the transaction. Instead, the doctrine of estoppel will likely be deployed to decide the case against that party. In one case, the owner of an apartment complex entered into an agreement for the purchase and sale thereof with a business that had not been registered as an LLC at the time of contract. Nevertheless, it was identified in the contract as an LLC.¹⁷³ The vendor attempted to back out of the contract and brought suit contending that the LLC lacked capacity to contract.¹⁷⁴ The LLC countered that the vendor was precluded from raising the want of legal organization as a defense to the parties' agreement and was estopped to deny the validity of the agreement, because it knowingly accepted benefits from the agreement, which agreement was not obtained by fraud.¹⁷⁵ In addition, after filing its

168. *Id.* at 672.

169. *Mastroianni v. Fairfield County Paving, LLC*, 942 A.2d 418, 421 (Conn. App. Ct. 2008).

170. *Id.* at 424.

171. *Id.*

172. *Supra* note 22 and accompanying text.

173. *Heritage Nat'l Assocs. LP v. 21st Inv. Group LLC*, 2000 WL 426437 (Tex. App. Dallas), at *1.

174. *Id.*

175. *Id.* at *2.

articles of organization, the LLC adopted the agreement.¹⁷⁶ The court noted that the vendor knowingly received and accepted benefits from the parties' agreement – \$25,000 in earnest money pursuant to the agreement.¹⁷⁷ Further noting that the Oklahoma LLC Act categorically declares that the law of estoppel applies to the Act, the court held that “in Oklahoma, a party who knowingly receives and accepts benefits from a real estate contract, absent a showing of fraud, is estopped to deny the validity of the contract.”¹⁷⁸

Similarly, another court held that since the parties were fully aware of plans to register the business as an LLC, and since the contract was partially performed by the LLC and was adopted by it soon after it became a registered LLC, the defendant was “estopped from denying existence of the limited liability corporation (LLC) [sic] and thus did not have right to withdraw from contract with LLC before LLC had been incorporated [sic].”¹⁷⁹ Nonetheless, a court may insist that a condition for holding the other party to the bargain is that the LLC eventually comes into existence.¹⁸⁰ That conclusion was reached in a case where the appellee sought to rescind the agreement to sell a horse stable to an LLC based upon the fact that the LLC had not been properly organized under West Virginia law as a limited liability company, contending that it had not entered into a binding contract with a competent party since the LLC did not technically exist at the time the deed was signed.¹⁸¹ Relying on some earlier cases from outside West Virginia,¹⁸² the court held that provided the entity is eventually created and receives delivery of the deed after its creation, “a deed drawn and executed in anticipation of the creation of the grantee as a corporation, limited liability company, or other legal entity entitled to hold real property is not invalidated because the grantee entity had not been

176. *Id.*

177. *Id.* at *3.

178. *Id.* See also *Heritage Nat'l Assoc.s LP v. 21st Investment Group LLC*, No. 05-99-00317-CV, 2000 WL 862811 (Tex. App. Dallas June 29, 2000) (holding that plaintiff suffered no damage or injury from defendant's delayed legal organization and therefore could not succeed on a fraud claim).

179. See also *P.D. 2000, LLC v. First Fin. Planners, Inc.*, 998 S.W.2d 108, 110-111 (Mo. Ct. App. 1999) (holding in relation to a contract that was entered into before the registration of the LLC, but in which it was specifically mentioned that the organizer was in the process of establishing the LLC and the LLC eventually adopted the contract, that the LLC was entitled to recover damages under the contract based on the doctrine of estoppel).

180. See *Heartland, LLC v. McIntosh Racing Stable, LLC*, 632 S.E.2d 296 (W. Va. 2006) (upholding deed notwithstanding LLC did not exist at time of signing but finding genuine issue of material fact in legal formation as condition precedent).

181. *Id.*

182. In particular, the court relied on *P.D. 2000*, 998 S.W.2d 108 and *Allen v. Scott, Hewitt and Mize, L.L.C.*, 186 S.W.3d 782, 784 (Mo. Ct. App. W.D. 2006), *transfer denied*, (Feb. 28, 2006) and *transfer denied*, (Apr. 11, 2006).

established as required by law at the time of such execution.”¹⁸³

There are situations where the courts are disposed to applying the de facto or estoppel concepts, or at least open to it, but do not do so because the case is decided on other grounds. In a breach of contract action, the plaintiff sued for a return of payment made to the defendant for work that the defendant did not complete.¹⁸⁴ The defendant claimed that he had no personal liability on the basis that the business was conducted through an LLC.¹⁸⁵ However, the LLC had not been formed at time of contract.¹⁸⁶ The defendant argued that “he believed he had formed the LLC, [and] when he learned, after the suit had been instituted, that the LLC had not been registered, he took immediate action to correct the problem and complete the registration with the defendant being the sole member.”¹⁸⁷ On the other hand, plaintiff argued that he thought he was dealing with the defendant individually. The pre-printed form that contained the agreement between the parties was headed “Louie’s Tree Service, LLC” but the heading also contained the words “Owner: L. D’Amico.”¹⁸⁸

The court declined to rely on a case cited by the defendant where a corporation had been dissolved but the third party, unaware of that fact, dealt with the corporation and never relied on the individual officers.¹⁸⁹ The court noted that that was “a different scenario than this case where the plaintiff, not unreasonably, thought he was dealing with an individual and the LLC had not even been established.”¹⁹⁰ It concluded that there was probable cause to find the defendant individually liable under the facts of the case.¹⁹¹ When the case came up for trial,¹⁹² the court recited the facts germane to the present discussion, which indicated that there was a good faith attempt to comply with statutory requirements for registration of an LLC, thereby strongly suggesting that a de facto LLC may have existed.¹⁹³

183. *Heartland*, 632 S.E.2d 296 at 303.

184. *Briga v. D’Amico*, No. CV040083317S, 2004 WL 772065, at *1 (Conn. Super. Ct. Mar. 24, 2004).

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.*

192. *Briga v. D’Amico*, No. CV040083317, 2006 WL 240557 (Conn. Super. Ct. Jan 12, 2006).

193. The pertinent facts are as follow:

Some time prior to November 1, 2000, Louis D’Amico had retained an attorney to create a limited liability corporation (LLC); had signed all of the documents prepared by the attorney; had paid all of the attorneys fees and filing fees for same; had received and reviewed all of the communications from the attorney as to the responsibilities and consequences of the existence of an LLC; and had set

However, the court held that there was no breach of contract since the plaintiff's additions to the defendant's proposal constituted a counter-offer which the defendant had not accepted and thus there was no contract.¹⁹⁴ Having decided the case on that ground, the court held that it was not necessary to decide the issue of the legal status of the defendant.¹⁹⁵

Where loss of de jure status is curable by actions required by a separate statutory provision applicable in certain circumstances, the court will give effect to it when the statutory conditions are met and protect LLC owners from personal liability or validate their transactions. In a pertinent case, the LLC placed orders with the plaintiff at various times including a period in which its status as an LLC was revoked. It did not pay plaintiff in full for those orders.¹⁹⁶ Plaintiff argued that by continuing to do business at a time they knew the company's status was revoked, the defendants were personally liable for the company's obligations.¹⁹⁷ The plaintiff anchored its argument on the provision of the Nevada statute that "[a]ll persons who assume to act as a limited-liability company without authority to do so are jointly and severally liable for all debts and liabilities of the company."¹⁹⁸ Defendants argued that they were not personally liable because since the company's status had been reinstated, the reinstatement related back to the date of the forfeiture of the company's right to transact business.¹⁹⁹ Relying on another Nevada statutory provision that a reinstatement relates back to the date on which the company forfeited its right to transact business and reinstates the company's right to transact business as if such right had at all times remained in full force and effect, the court held that the defendants were not personally liable for the LLC's debts.²⁰⁰

up separate bank accounts, letterhead, etc. for the newly created "Louie's Tree Service, LLC." When Mr. D'Amico was served with this lawsuit, naming him individually as a defendant, he learned from his attorney that the filing of the LLC had not been accomplished at the office of the Secretary of State for the State of Connecticut. The attorney then immediately filed a second set of Articles of Organization for "Louie's Tree Service, LLC." It is the position of Mr. D'Amico that the proper defendant in this action is the de facto limited liability corporation [sic] and that he is not personally responsible.

Id. at 3.

194. *Id.* at *4

195. *Id.*

196. *Nichiryō America, Inc. v. Oxford Worldwide, LLC*, No. 03:07-CV-00335-LRH-VPC, 2008 WL 2457935, at *3 (D.Nev. June 16, 2008).

197. *Id.*

198. NEV.REV.STAT. § 86.361 (2008) (cited in *Nichiryō*, 2008 WL 2457935 at *3).

199. *Nichiryō*, 2008 WL 2457935 at *3.

200. *Id.*

C. Cases Rejecting De Facto LLC or LLC By Estoppel

In some states where the de facto doctrine has been abolished with respect to corporations, the courts have held that LLCs are encompassed in the abolition. Thus, where articles of organization were drafted and signed but were not filed with the secretary of state, the court noted that the de facto corporation doctrine has been abolished in Minnesota and held that the prohibition extended to LLCs.²⁰¹ In the same vein, since the corporation by estoppel doctrine was still valid in the state, despite the inapplicability of the de facto corporation doctrine, the court was amenable to the application of the LLC by estoppel doctrine.²⁰² The court noted, however, that “assum[ing], without deciding, that the corporation-by-estoppel doctrine applies to LLCs,” it would not apply in the instant case since the conveyance of the property to the LLC was induced by fraud.²⁰³

Drawing guidance from an earlier Utah case that held that the Utah legislature had abrogated the corporation by estoppel doctrine, the U.S. Court of Appeals for the Tenth Circuit held that an analogous provision in the Utah LLC statute similarly abrogated the concept of LLC by estoppel.²⁰⁴ Since the case relied upon by the Tenth Circuit also held that the de facto corporation doctrine had been abolished, it follows that de facto LLCs also cannot exist under the current statutory scheme in Utah.²⁰⁵

Addressing the pertinent issue of pre-organization status, a Virginia court stated that “Virginia has adopted the Model Business Corporation Act, and like other states enacting the Model Business Corporation Act, has

201. *Stone v. Jetmar Properties, LLC*, 733 N.W.2d 480, 485 (Minn. Ct. App. 2007).

202. *Id.* at 487.

203. *Id.* at 487-88. *See also* *Lake State Fed. Credit Union v. Tretsven*, No. A07-1542, 2008 WL 2732111 (Minn. Ct. App. July 15, 2008) (holding that while a bona-fide purchaser of real property ordinarily has superior rights to a previous purchaser whose title was not recorded, the argument was not availing where the bona fide purchaser was an unregistered LLC at the time the property was issued in its name); *Brcka v. Falcon Electric Corp.*, No. C8-00-1434, 2001 WL 641524 (Minn. App. June 12, 2001) (rejecting a corporation by estoppel argument because there was no evidence that the parties sought to be estopped did anything to hold out or represent the business as an LLC or that the business in any way functioned as an LLC while, on the contrary, the evidence in the record showed that when the failed incorporation was discovered, the parties agreed to treat the business as a partnership).

204. *Shelter Mortgage Corp. v. Castle Mortgage Company, LC*, 117 Fed. Appx. 6, 14 (C.A. 10 Utah 2004).

205. *Id.* *See also* *Berrios-Bones v. Nexidis, LLC*, No. 2:07CV193DAK, 2007 WL 3231549 at *10 (D. Utah Oct. 30, 2007) (holding that it was a question of fact as to whether liability would be imposed under the Utah statute that states that “all persons who assume to act as a company without complying with this chapter are jointly and severally liable for all debts and liabilities so incurred” in a case where an allegedly unregistered LLC had purchased 100 percent of the membership interest of an existing LLC and assumed control of its operations).

completely abolished the old common law doctrine of *de facto* corporate existence.²⁰⁶ Proceeding along that line of reasoning, the court held that as a consequence, “Virginia does not recognize the doctrine of *de facto* existence in regards to limited liability companies.”²⁰⁷ The court’s pronouncement on the import of the adoption of the Model Business Corporation Act on the *de facto* doctrine is open to question. Moreover, Virginia’s extant corporate statute is based on the current revision of the Model Act. This version is a retreat from previous versions that doubted the continued existence of the *de facto* doctrine or pointedly rejected it.²⁰⁸

A similar situation appears to have played out in Tennessee, which abolished the *de facto* corporation doctrine under a 1968 Corporations statute that was based on an older version of the MBCA,²⁰⁹ but the state has since adopted the 1984 version, which, arguably, has restored the doctrine in the state.²¹⁰ Faced with conflicting accounts as to the exact business organization that was in the parties’ contemplation, the Tennessee court of appeal responded:

Notwithstanding Ms. Harvey’s assertion, if an entity is operating as a business it *must* exist as some form of entity. Because more than one party was an owner, it is clear that International was not operating as a sole proprietorship. It is also clear that neither party took the steps required under statute to make International a limited partnership, limited liability partnership, or a limited liability company. Neither party intended International to become a corporation, took any steps to register it as such, nor acted as if International was a corporation. As such, International was none of the business entities listed above. However, International still operated as a business and this fact *requires* this court to determine what specific type of entity International operated as during this period. The only business entity that this court has not yet rejected is that of a partnership.²¹¹

206. Geographic Network Affiliates-Intern., Inc. v. Enterprise for Empowerment Foundation at Norfolk State Univ., 68 Va. Cir. 185 (Va. Cir. Ct. 2005).

207. *Id.*

208. “All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this chapter, are jointly and severally liable for all liabilities created while so acting except for any liability to any person who also knew there was no incorporation.” VA. CODE ANN. § 13.1-622 (2006). Virginia, however, has no similar provision for LLCs.

209. See Thompson & Green v. Music City Library Co. 683 S.W. 2d 340, 344 (Tenn. Ct. App. 1984) (holding that the *de facto* corporation doctrine has been abolished by the enactment of the Tennessee General Corporations Act of 1968).

210. Brandon Bass, *Are There De Facto Corporations in Tennessee?*, TENNESSEE BUSINESS LITIGATION LAW BLOG, <http://www.tnbusinesslitigation.com/business-entities-are-there-de-facto-corporations-in-tennessee.html> (last visited July 5, 2009).

211. Harvey v. Covington, No. M2000-01184-COA-R3-CV, 2001 WL 120733, at *3

Noting that the “intentions, understanding or terminology used by the parties is irrelevant to the formation of a partnership,” the court held that the business was as a general partnership.²¹² What is striking is that the court completely glossed over the fact that a de facto entity may have existed, or that the concept of LLC by estoppel would have barred one party from insisting that the business was not an LLC after apparently recognizing it as one. Instead, it chose to focus on the requirements for de jure existence.²¹³ The oversight may have been purposeful, however, signifying the court’s intention not to apply either defective registration doctrine, based on the fact that the same court had declared almost two decades earlier that Tennessee had abolished the de facto doctrine for corporations.²¹⁴

Even in states where the de facto LLC doctrine has been recognized, the courts are not always eager to embrace the doctrine, as exemplified by a case in which a notice to quit, dated October 11, 2006, was served on the defendants on October 12, 2006, but the plaintiff LLC was not organized until November 16, 2006.²¹⁵ The plaintiff maintained that although it had not been formally registered with the Secretary of State as an LLC at the time it issued a notice to quit and commenced the lawsuit, it was a de facto LLC at the time the action commenced.²¹⁶ The defendant moved to dismiss. Without directly addressing the de facto issue or pointedly rejecting it, the court held that “it is clear from the parties’ submissions that [the LLC] was not a legal entity in existence at the time the notice to quit was issued and at the time this action was commenced. Therefore, the plaintiff lacked the legal capacity to sue prior to November 16, 2006.”²¹⁷

While the non-recognition of the de facto or estoppel concept often works to the disadvantage of LLC organizers, LLCs’ founding entrepreneurs and other investors are also able to use non-recognition to their advantage in evading obligations, including governmental regulations. A general partnership purported to convey commercial property to an LLC that was never registered with the Commonwealth of Pennsylvania.²¹⁸ Subsequently, the “LLC” conveyed the commercial real estate to a third party.²¹⁹ After both conveyances, the Pennsylvania Department of State assessed a real estate transfer tax upon the “LLC.” To avoid paying the

(Tenn. Ct. App. Feb. 14, 2001) (citations omitted).

212. *Id.*

213. See *id.*

214. *Supra* note 209 and accompanying text.

215. 54-56 Broadway, LLC v. Smithfield Assoc., LLC et al., No. 15549, 2007 WL 865826, at *1 (Conn. Super. Ct. Mar. 5, 2007).

216. *Id.*

217. *Id.* at *3.

218. Lester Assocs. v. Commonwealth, 816 A.2d 394, 396 (Pa. 2003).

219. *Id.*

transfer tax, the “LLC” contended that the deed from the partnership was void *ab initio* and thus, there was no transfer of real estate to justify the imposition of the real estate transfer tax.²²⁰ It argued that it was not capable of taking title at the time of the conveyance and therefore should be under no obligation to pay the assessed taxes.²²¹ The court accepted the “LLC’s” arguments and declined to accord legal existence to an unformed LLC, holding that both the conveyance to the “LLC” and the subsequent purported conveyance by the “LLC” were void.²²² Accordingly, the court found no justification for the imposition of the real estate transfer tax.²²³

There may also be some judicial hesitance to dive into a discussion of the concepts, unless clearly warranted by the particular dispute before the court. However, there also does not seem to be a rush to pronounce the business relationship a “general partnership.” The Delaware Chancery Court, in a case where one party sought to recover on a general partnership theory from another when their negotiations to form an LLC failed, was content to raise a hypothetical question in a footnote²²⁴: “What if, for example, two parties agreed on all material terms of an LLC agreement, conducted business in accordance with that agreement for a time, but one party later refused to sign the LLC agreement and claimed exclusive rights? Might they be deemed general partners?”²²⁵ The court, while noting that those circumstances were different from the ones presented in the case before it, did not proceed further to characterize the relationship described as a *de facto* LLC or LLC by estoppel. Perhaps, the court chose to concentrate its attention on dismissing the claim that the parties formed a general partnership instead of pronouncing on issues or arguments not before it.²²⁶ The court also stated that where it is the clear intention of the parties to formalize their business relationship through a written LLC agreement, instead of opting for a general partnership, “reality serves as an important factor that cuts against concluding that they had earlier formed a general partnership because their attempt to forge an agreement on the material terms of a written LLC contract eventually came to naught.”²²⁷

220. *Id.* at 398.

221. *Id.*

222. *Id.*

223. *Id.*

224. *Ramone v. Lang*, No. Civ.A. 1592-N, 2006 WL 905347 (Del. Ch. Apr. 3, 2006).

225. *Id.* at *14 n.64.

226. This point is underscored by the court’s conclusion to the following effect: “To consider *Ramone* and *Lang* partners would make it hazardous for businesspersons to agree to negotiate the formation of an LLC together without risking a judicial declaration that they thereby created a *de facto*, informal partnership if their negotiations fail.” *Id.*

227. *Id.*

D. Analysis of Cases

There is a strong indication that courts faced with pre-organization obligations of LLCs are likely to follow the existing direction in their state regarding de facto corporations and corporations by estoppel.²²⁸ Yet, the fact that a state recognizes de facto corporations and corporations by estoppel does not necessarily equate to an extension of a similar recognition in the case of LLCs.²²⁹ For instance, although Kansas's corporate statute left room for the existence of de facto corporations, the state's initial LLC statute seemed to foreclose that possibility.²³⁰

Conversely, it may not be easily assumed that because a state has abolished the de facto and estoppel concepts in the corporate context, it has automatically done so in the LLC context. Such an assumption may be injurious to the interests of LLC investors in those states and may run contra to the evinced intention of the legislature to depart from the previously existing direction. This problem is illustrated by *Pound v. Airosol Co.*, a relatively recent decision of the U.S. District Court in Kansas in a case involving the application of Colorado law.²³¹ The court held that prior to the issuance of a certificate of incorporation under Colorado law, there was no corporate entity and that the de facto corporation doctrine had been abolished, even if there has been a colorable attempt at complying with the statute regulating the formation of corporations.²³² In arriving at this conclusion, the court relied on Colorado decisional law that interpreted the state's corporations statute. The Colorado statute was based on a version of the MBCA that was generally

228. See e.g., *Shelter Mortgage Corp. v. Castle Mortgage Co.*, 117 Fed. Appx. 6 (rejecting both de facto LLC and LLC by estoppel because analogous concepts in the corporate context had been abolished in Utah); *Stone v. Jetmar*, 733 N.W.2d 480, 485-86 (Minn. Ct. App. 2007) (drawing guidance on the interpretation and application of the law governing LLCs from the law governing corporations and concluding that the de facto "doctrine has been abolished in the context of business-corporation law and, by extension, in the context of LLC law."); *Simsbury-Avon Preservation Society, LLC v. Metacon Gun Club, Inc.*, No. CV040834190S, 37 Conn. L. Rptr. 726, 2004 WL 2094933 (Conn. Super. Ct. Aug 20, 2004) (finding no sufficient basis for not applying the de facto corporation doctrine recognized in Connecticut to a Connecticut LLC); *Leber Associates, LLC v. Entertainment Group Fund, Inc.*, No. 00 Civ.3759 LTS MHD, 2003 WL 21750211 (S.D.N.Y. July 29, 2003) (applying Delaware's de facto corporation doctrine to a Delaware LLC).

229. See *Darst*, *supra* note 6, at 303, 324 (arguing for legislative amendment to accord the treatment available in pre-formation transactions to corporations in Arkansas to LLCs in that state); see also *Matthews*, *supra* note 30, at 813-14 (predicting the analysis of liability under defective formation by analogy to other entity types).

230. *Darst*, *supra* note 6, at 317-18.

231. *Pound v. Airosol Co.*, 368 F.Supp.2d 1210 (D. Kan. 2005).

232. *Id.*

seen as abrogating the defective incorporation doctrines.²³³

The current version of the statute is substantially different²³⁴ and is similar to the LLC statute which provides: “All persons who assume to act as a limited liability company without authority to do so and without good faith belief that they have such authority shall be jointly and severally liable for all debts and liabilities incurred by such persons so acting.”²³⁵ Thus, in enacting a new corporations statute and an LLC statute, the Colorado legislature used language that, by shielding organizers from personal liability if they had a good faith belief they had the authority to act, may be understood as permitting the existence of corporations and LLCs that have not satisfied the requisite organizational requirements.²³⁶ It is expected that a court faced with the interpretation of the Colorado LLC statute would hold that the statute permits the existence of de facto LLCs, instead of being guided by previous decisions, which held that de facto corporation doctrine has been abolished in the state. Similarly, a court presented with the issue in the corporate context is also expected to take the legislative change into account.

It is puzzling that *Pound* came up after the statutory change and yet the court reached a result not dissimilar from the conclusions under the previous statutory scheme. Accordingly, at the earliest opportunity, the state’s top court may want to consider overruling the previous decisions and restore the recognition of the defective incorporation doctrines.

Another observation from the cases is that, as has been the case in the corporate context, it is possible in some states to recognize LLCs by estoppel without according a similar recognition to de facto LLCs.²³⁷

233. *Black Canyon Citizens Coalition, Inc. v. Bd. of County Comm'rs of Montrose County*, 80 P.3d 932, 933 (Colo. App. 2003); *Bowers Bldg. Co. v. Altura Glass Co.*, 694 P.2d 876 (Colo. App. 1984).

234. “All persons purporting to act as or on behalf of a corporation, without authority to do so and without good faith belief that they have such authority shall be jointly and severally liable for all liabilities incurred or arising as a result thereof.” COLO. REV. STAT. § 7-102-104 (2006).

235. COLO. REV. STAT. § 7-80-105 (2006).

236. See Sylvester J. Orsi, *The Limited Liability Company: An Organizational Alternative for Small Business*, 70 NEB. L. REV. 150, 154 n.27 (1991) (stating that the Colorado LLC statute “grants limited liability to persons who act with an honest, but erroneous belief that they had authority to do so.”). See also BISHOP & KLEINBERGER, *supra* note 16, ¶ 6.02[2][c][i] (stating that Iowa and Colorado “take a more modern approach by adding a scienter requirement”) (citation omitted); Thomas E. Rutledge, *Limited Liability (or not): Reflections on the Holy Grail*, 51 S.D. L. REV. 417, 431 (2006); Scott R. Anderson, *The Illinois Limited Liability Company: A Flexible Alternative for Business*, 25 LOY. U. CHI. L.J. 55, 72 n.98 (1993).

237. See RAGAZZO & MOLL, *supra* note 42, at 296 (stating that unlike de facto corporations, corporations by estoppel survived the adoption of the Model Act in the District of Columbia); *Namerdy v. Generalcar Corp.*, 217 A.2d 109, 112 (D.C. 1966) (upholding the defense of corporations by estoppel). See also *Stone v. Jetmar*, 733 N.W.2d 480, 487

While this situation leaves LLC organizers in a better shape than in jurisdictions where there is outright rejection or unavailability of either defective registration concept, the protection afforded is still limited. Business owners are still exposed to liability in tort and non-voluntary transactions, since the estoppel concept does not afford protection from personal liability in those circumstances.²³⁸ Even in the case of contract, escape from personal liability is not assured in all cases. Where a business owner or owners legitimately believe that they were duly registered as an LLC (for example, because their attorney who was instructed to register the business so informed them) but have not ordered business stationery or erected sign posts that have the designation “LLC” after the business name, they may be held unlimitedly liable if, during the period of non-registration, a third party contracts with them believing the business is a sole proprietorship (especially if she always met and dealt with one person) or a general partnership. It would be difficult or impossible to sustain an argument that estoppel bars the third party from recovering against them personally or avoiding the transaction to evade her obligations. After all, the third party did not deal with the business on the understanding that it was an LLC, which is the basis of an estoppel defense. On the other hand, if the business is a formally organized LLC or if the de facto LLC doctrine is recognized in the jurisdiction, the business owners would be protected from personal liability, considering that they made a good faith effort to register as an LLC.

Another crossover from the corporate context is the persisting tendency to conclude that because the process of formal organization has been simplified and streamlined, it is impossible to satisfy a basic prerequisite for the application of the de facto doctrine, namely a colorable attempt to comply with the relevant statute. The Minnesota Court of Appeals resorted to this point as a basis for refusing to accord recognition to the notion of a de facto LLC.²³⁹ According to the court, “the LLC statute provides organizers with an indisputably simple route to formal organization. Thus, it is doubtful that one could actually make an unsuccessful ‘colorable attempt’ to organize a de jure LLC.”²⁴⁰ However, the corporate experience has demonstrated the questionability and futility of rejecting the de facto doctrine on that basis.²⁴¹

(Minn. Ct. App. 2007) (rejecting de facto LLC doctrine but leaving room for the application of LLC by estoppel, basing both positions on the applicable rules for Minnesota corporations).

238. RAGAZZO & MOLL, *supra* note 42, at 292.

239. *Stone v. Jetmar*, 733 N.W.2d at 486.

240. *Id.* at 486 n.2.

241. See MODEL BUS. CORP. ACT § 50 cmt. (1960) (“Since it is unlikely that any steps short of securing a certificate of incorporation would be held to constitute apparent compliance, the possibility that a de facto corporation could exist under such a provision is

In some of the cases, the courts appear to be open to accepting the de facto or estoppel doctrine but constrained to withhold recognition, not because of any legal objection, but because under the facts the parties have not met the requirements for application of the doctrines,²⁴² or the doctrines are not germane to the resolution of the cause at hand. In *Briga v. D'Amico*, the parties entered into a "contract" to clear some land of trees. The defendant contended that his company was a "de facto" LLC.²⁴³ The court resolved the breach of contract issue by reference to contract law but did not pronounce on the issue of de facto LLC.²⁴⁴ This judicial posture of openness and absence of outright hostility certainly bodes well for the development and widespread recognition of the concepts of de facto LLC and LLC by estoppel.

Finally, it is difficult to establish the significance, or lack thereof, of statutory silence in the application or rejection of the de facto and estoppel concepts. For instance, Connecticut and New York do not have assume-to-act provisions, whether with or without a knowledge requirement.²⁴⁵ A number of courts in the two states have applied or approved the application of the de facto and estoppel concepts.²⁴⁶ The argument could thus be made that while the application of the concepts would be better guaranteed under a legislative scheme that expressly provides for no personal liability under certain circumstances where pre-formation obligations would arise, it does not appear to be particularly harmful that the legislature has chosen to be silent on the issue. Nevertheless, the legislature's silence may endanger the existence of the concepts where the state has settled the issue in the corporate context. One example is Minnesota, where the LLC statute is silent but the courts have ruled out the application of the de facto concept in the LLC context, while leaving room for LLCs by estoppel, based on the state of the corporate law in the state.²⁴⁷ On the other hand, in the two states mentioned above, the de facto corporation doctrine is alive, explaining why the courts have accepted the doctrine of de facto LLCs. In situations, such as under Utah law, where both the corporate experience

remote."); MODEL BUS. CORP. ACT § 146 cmt. (2d ed. 1971) (stating that no reason exists for the continuance of the de facto corporation doctrine "under general corporate laws, where the process of acquiring de jure incorporation is both simple and clear."). The 1984 version acknowledged the failure of these efforts and decided to adopt a slightly more flexible or relaxed standard. *Supra* note 109 and accompanying text.

242. *Leber Associates, LLC v. Entertainment Group Fund, Inc.*, No. 00 Civ.3759 LTS MHD, 2003 WL 21750211 (S.D.N.Y. July 29, 2003).

243. *Briga v. D'Amico*, No. CV040083317S, 2004 WL 772065, at *1 (Conn. Super. Ct. Mar. 24, 2004).

244. *Id.*

245. RIBSTEIN & KEATINGE, *supra* note 17, at Appendix 4-3.

246. *See supra* notes 151-53 and accompanying text.

247. *See supra* notes 199-203 and accompanying text.

and an assume-to-act provision exist, the chances of the survival of the doctrines in the LLC context appear to be nil.²⁴⁸ A fair conclusion could be that silence does not necessarily count for much, as the corporate experience seems to loom large over this issue for LLCs. A fortiori, the case for clear LLC legislative provisions cannot be overemphasized.

Professors Bishop and Kleinberger, after an extensive review of the problems surrounding the de facto concepts in the corporate and LLC contexts, made the following conclusion and recommendation:

For any particular jurisdiction, shield-related rules for corporations and for limited liability companies should be synchronized. Neither entity should enjoy a shield-related advantage or suffer a shield-related disadvantage. Therefore, jurisdictions that respect the de facto or estoppel doctrine for corporations should do likewise for limited liability companies. Jurisdictions that reject those doctrines for corporations should likewise reject them for LLCs.²⁴⁹

This work partially accepts the synchronization proposal. For reasons explained in the next part, I argue that the laws should be synchronized to favor the application of de facto and estoppel concepts to LLCs. Accordingly, any state that opts to recognize either or both of the concepts in the LLC context should harmonize its corporate law to align with this position. States that already recognize the concepts in the corporate context but have an opposite provision for LLCs or have not made an explicit provision one way or another in the LLC context should synchronize their laws to recognize de facto LLCs and LLCs by estoppel.²⁵⁰ Part IV below presents a more detailed proposal for legislative reform in favor of the application of the de facto and estoppel concepts in the LLC context.

V. A PROPOSAL FOR LEGISLATIVE REFORM

Many states impose personal liability on those who conduct business as an LLC prior to formation through what has been referred to as ‘assume-to-act’ or ‘purporting-to-act’ provisions.²⁵¹ For instance, the Alabama LLC

248. See *supra* notes 204-05 and accompanying text.

249. BISHOP & KLEINBERGER, *supra* note 16, ¶ 6.02 [2][d][iii], at 10.

250. According to one commentator: “Thirty-two states contain statutes similar to either the 1969 or the 1984 Model Act, and twelve contain a similar provision in their LLC statutes. . . . [T]he pre-organization provisions for corporations and LLCs do not always go hand in hand. A state may have the 1984 version for corporations and the 1969 version for the LLC, such as Arizona and Alabama. Alternatively, a state, for example Arkansas, may have a statute for one entity and not the other.” Darst, *supra* note 6, at 317 (citations omitted).

251. See RIBSTEIN & KEATINGE, *supra* note 17, at § 4:15. Some other states have

statute provides: “All persons who assume to act as a limited liability company without authority to do so shall be jointly and severally liable for all debts and liabilities created by their so acting.”²⁵²

Although some assume-to-act provisions (in the corporate context) have been liberally construed to exclude passive investors²⁵³ and to require some level of culpability,²⁵⁴ a preferable approach would be to exclude clearly from personal liability two categories of investors: those who are not aware of the lack of registration as an LLC and those who are not active participants in the business.²⁵⁵ This just result can be accomplished by incorporating a knowledge component in the assume-to-act provisions.²⁵⁶ An example of this latter approach can be found in the revised Florida LLC Statute which provides:

All persons purporting to act as or on behalf of [an LLC], having actual knowledge that there was no organization of [an LLC] under this chapter, are jointly and severally liable for all liabilities created while so acting except for any liability to any person who also had actual knowledge that there was no organization of [an LLC].²⁵⁷

Along similar lines, this work proposes that state LLC statutes incorporate a provision that imposes no personal liability unless there is knowledge of the lack of registration by those actively involved in the

declined to follow that course. *Id.*

252. ALA. CODE § 10-12-7 (2009).

253. *See, e.g.,* Timberline Equip. Co. v. Davenport, 514 P.2d 1109, 1113-14 (Ore. 1973) (stating that “the category of ‘persons who assume to act as a corporation’ does not include those whose only connection with the organization is as an investor . . . [but does] include those persons who have an investment in the organization and who actively participate in the policy and operational decisions”).

254. *See e.g.,* Mobil Oil Corp. v. Thoss, 385 So. 2d 726 (Fla. App. 1980); Harry Rich Corp. v. Feinberg, 518 So. 2d 377, 381 (Fla. Dist. Ct. App. 1987) (construing assume-to-act as not imposing personal liability in the absence of actual or constructive knowledge on the part of the defendant that there had been no incorporation). *See also* U. S. Fid. & Guar. Corp. v. Putzy, 613 F. Supp. 594 (N.D. Ill. 1985) (stating that “only incorporators or others who actively conduct corporate business can be held liable for the debts of the corporation at common law”).

255. Roland J. Santoni, *Why Nebraska Should Adopt the Revised Model Business Corporation Act*, 28 CREIGHTON L. REV. 149, 152 (1994) (stating that under a purporting to act provision with a scienter requirement, “passive investors in a corporation avoid the risk of personal liability for pre-incorporation transactions, as do other active participants who honestly and reasonably, but erroneously, believe that articles of incorporation had been filed”).

256. *See Task Force Report: Oregon Revised Model Business Corporation Act*, 30 WILLIAMETTE L. REV. 407, 418 (1994) (stating that the inclusion of a knowledge component “protects participants who act honestly but subject to the mistaken belief that the articles have been filed”).

257. FLA. STAT. ANN. §608.4238 (West 2010).

running of the purported LLC.²⁵⁸ That way, the law punishes only those who clearly intend to skirt the provisions of the LLC statute or are egregiously indifferent to the law's dictates. This proposal, therefore, is along the lines of the current state of corporate law under the MBCA as adopted by numerous states.²⁵⁹ Furthermore, those who present an unorganized business as an LLC, or enter into transactions with it on that understanding, should not be provided an escape valve to avoid their obligations when the circumstances turn unpalatable. In addition, those who act on behalf of an LLC knowing there is no formal organization will always be personally liable for obligations arising in tort or non-voluntary aspects of a contractual transaction. Also, the only time such people will be protected in contract is when the third party clearly knew it was dealing with an LLC and expressly or tacitly chose to make the LLC the sole obligor.²⁶⁰ Section A below elaborates on the rationale for this proposal and Section B presents a taxonomy of applicable situations, while Section C provides a forceful critique.

A. *Rationale for Proposal*

This paper has developed a seven-fold rationale for recognizing the estoppel and de facto concepts in the context of LLCs. Recognizing these concepts in the limited circumstances proposed here will promote statutory compliance, provide creditor protection, secure land titles, reduce investor risk, obviate incommensurate punishment, prevent windfall profits and ensure prudence in the design and implementation of business policy.

1. Compliance Promotion

A major goal of not recognizing de facto and estoppel concepts is to ensure compliance with statutory provisions on registration by not lending

258. At the moment, similar to the situation with corporations, some LLC statutes incorporate a knowledge component to their purporting-to-act provisions, while some others do not or leave the issue entirely open. Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L. Q. 455, 464 n.36 (1995).

259. See Mitchell F. Crusto, *Green Business: Should we Revoke Corporate Charters for Environmental Violations*, 63 LA. L. REV. 175, 187 (2003) (discussing the MBCA provision on this point); John Morey Maurice, *The 1990 Washington Business Corporation Act*, 25 GONZ. L. REV. 373, 385 (1990) (stating that the purporting to act provision adopted in the state of Washington "does not apply to persons who do not know that the corporation does not yet exist").

260. See Levinsohn, *supra* note 21, at 287 (suggesting that in order to successfully raise an estoppel, there should be "a showing that the associates assumed to do business as a corporation and the third person, as a reasonable man, understood that he was dealing with the association as a corporation").

credibility to those in non-compliance.²⁶¹ Such a rigid stance, however, achieves unfair results and has proven unworkable in many cases. The proposed approach will address the compliance issue in a good number of cases. It may not accomplish the envisaged complete compliance objective of assume-to-act provisions lacking a knowledge component, but it also does not drastically undermine compliance through an endorsement of blanket immunity for those who incur pre-formation obligations.

2. Creditor Protection

The registration of LLCs provides notice to third parties of the status of the company, the individuals behind the business and the level of their financial involvement in the entity.²⁶² Information of this nature could provide a level of protection as it enables potential creditors to act on an informed basis and decide if it is worthwhile to expose themselves to the risk of doing business with a particular company. In view of the fact that the proposal here generally supports formal registration as opposed to a proposal that grants the benefit of registration in more generous situations to those who have not made efforts to register as an LLC, the present proposal could be seen as aiding creditor protection unlike one alternative that grants blanket immunity for those who incur preformation obligations.

3. Title Security

Additional justification for the application of the de facto concept to LLCs can be found in the fact that it can ensure that land titles are secure, instead of unduly placing transferees in jeopardy and unnecessarily increasing the workload of public officials.²⁶³ De facto corporations have

261. 1 MODEL BUS. CORP. ACT ANN. § 2.04, official cmt. at 2-46, illustration 4 (3d ed. Supp. 1997) (stating that “to recognize limited liability in this situation threatens to undermine the incorporation process, since one may obtain limited liability by consistently conducting business in the corporate name.”); Dodd, *supra* note 73, at 551, 557.

262. See CALLISON AND SULLIVAN, LLCs, *supra* note 140.

The various state LLC statutes differ concerning the information which must be provided in the LLC’s article of organization Some states require less information than others, and filing information can be limited to such matters as the LLC’s name and the name and address of its registered agent. Other statutes require more information, such as a statement of the LLC’s business purpose, its duration, a disclosure of whether the LLC will be managed by its members or managers, information concerning the members and/or the managers, limitations on the managers’ or members’ powers to bind the LLC to third parties, the contributions made or to be made by members, the right to admit additional members, and other information concerning the LLC and its finances.

263. See 2 PATTON AND PALOMAR ON LAND TITLES § 406 (3d ed. June 2009) (stating that an LLC would be able to acquire title to land if the courts construe LLC statutes similarly to

long been permitted to hold and convey title to property.²⁶⁴ They may also bring an action to eject strangers to their title or sue trespassers in tort.²⁶⁵ This practice would be extended to de facto LLCs where the concept is recognized.²⁶⁶ Speculating on what some state courts would do, one commentator asserts:

[I]t would be unreasonably burdensome to require that the title searcher examine the Secretary of State's records for each limited liability company in a chain of title to determine its legal existence at the time of conveyance. It is probable that the concept of a de facto LLC would be applied by Vermont courts to deal with the problem of acquisition of title to real property by an LLC which initial articles of organization had not been filed with or accepted by the Secretary of State at the time of a conveyance into a purported LLC. Similarly, a conveyance by an LLC of property in its name where the LLC had not been properly formed, or which having been properly formed, had been dissolved, raises the same question as in the corporate context. It would seem reasonable and practical to assume that courts would apply a de facto LLC doctrine to recognize the validity of such conveyances.²⁶⁷

In *Allen v. Scott, Hewitt and Mize, LLC.*, the Missouri Court of Appeals held that an LLC was capable of receiving a valid conveyance irrespective of the fact that it had not completed the organization process, adding that a subsequently formed entity may have equitable rights with regard to a conveyance made before its formation.²⁶⁸ In *the Matter of Hausman*, the appellate division of the New York Supreme Court concluded that a de facto LLC can take title to property.²⁶⁹ However, it held that no de facto LLC existed at the time the deed in question was executed since there was no colorable attempt to comply with the statute

corporate law by recognizing de facto LLCs in cases of defective formation or involuntary dissolution, adding that “[t]his reasoning would permit only the state to raise defects in forming and constituting the company as grounds to question its capacity to acquire title”) (citation omitted).

264. JOHN L. SOILEAU & G. ROBERT ARNOLD, *FLORIDA REAL PROPERTY SALES TRANSACTIONS* § 6.53 (2004) (“Originally, a conveyance to and from a de facto corporation was considered a valid conveyance.”).

265. Levinsohn, *supra* note 21, at 290.

266. See 16 N.Y. JUR. 2D BUSINESS RELATIONSHIPS § 2156 (May 2009) (stating that the recognition in New York that an unincorporated entity can take title to real property is equally applicable to LLCs, provided that a colorable attempt was made to comply with the statute governing organization prior to the purported acceptance of the deed).

267. Anderson, *Title Issues*, *supra* note 19, at 161.

268. *Allen v. Scott, Hewitt and Mize, LLC*, 186 S.W.3d 782, 784 (Mo. Ct. App. W.D. 2006), *transfer denied*, (Feb. 28, 2006) and *transfer denied*, (Apr. 11, 2006).

269. *In Re. Hausman*, 51 A.D.3d 922, 924, 858 N.Y.S.2d 330 (N.Y.S.App. 2008).

governing the organization of LLCs.²⁷⁰ Allowing putative LLCs to hold property is also important for the protection of the interest of innocent third parties who have relied in good faith on the LLC's ownership of the property.²⁷¹

An objection to allowing de facto LLCs to hold property is the conflict it engenders with a public policy of encouraging entities to be properly organized. As the court reasoned in *Stone v. Jetmar*,²⁷² “[a]llowing a form of future interest to vest in unorganized entities would be inconsistent with our public policy of encouraging legal organization.”²⁷³ On the other hand, a credible point can be made that a public policy that favors the holding and conveyance of property by de facto LLCs is founded upon considerations of necessity, for the protection of the public and individuals whose interests otherwise may be adversely affected.²⁷⁴ Thus, it is to a reasonable extent an analogue of the doctrine that confers validity to the acts of officers de facto, regardless of any defects that may exist pertaining to the legality of their appointment or election.²⁷⁵ A little more than a century ago, Professor Edward Warren

270. *Id.* at 924l; *but see* *Stone v. Jetmar Properties, LLC*, 733 N.W.2d 480, 486 (Minn. Ct. App. 2007) (holding that a deed conveying property to an unregistered LLC was void); *Lake State Fed. Credit Union v. Tretsven*, No. A07-1542, 2008 WL 2732111 (Minn. App. July 15, 2008) (holding that an unregistered LLC could not claim a mortgage interest in property issued in its name prior to registration).

271. *See* KALINKA, *supra* note 19, at § 1.37 (stating that “where third parties have relied in good faith on the LLC's ownership of an immovable [property], a court might apply an estoppel theory to validate the LLC's transactions with respect to the property”).

272. *Stone v. Jetmar*, 733 N.W.2d at 487.

273. *Id.*; *Lake State Fed. Credit Union*, 2008 WL 2732111, at *3.

274. *See* *Jordan v. Knox County*, 213 S.W.3d 751, 774 (Sup. Ct. Tenn. 2007) (referencing a U.S. Supreme Court opinion making a similar point in relation to de facto officers).

275. *Id.* The recognition for de facto officers is limited, however, as inquiries into the legality of their appointment may still continue under proper proceeding while their acts are recognized. In the case of de facto corporations or LLCs holding or conveying title, establishing that they are de facto entities would end the inquiry. Nonetheless, the effect on the issue of holding title is similar. Just as titles by de facto entities are recognized, acts of de facto officers (even if removed eventually) may still remain valid. As the Tennessee Supreme Court remarked about the actions of a sheriff who lacked eligibility to serve:

At the time the deed was executed . . . Newman was the acting sheriff of the county under an election made in due form; and although he was, at the time of his election, ineligible on account of his defalcation, yet this does not avoid his acts done as sheriff before his election was annulled by the proper authority; previous to the event, though he was not sheriff *de jure*, yet he was *de facto*; and from public necessity, the acts of a public officer, exercising his office *de facto*, though not *de jure*, are valid as to third persons, and cannot be controverted in a collateral issue such as this.

Bates v. Dyer, 28 Tenn. (9 Hum.) 162, 163 (1848) (quoted in *id.* at 775). Another difference is that the de facto officer doctrine is applied for the benefit of those dealing with such

remarked: “The considerations of public policy moving the courts to facilitate [real estate] transactions may not be so urgent as those respecting transactions with public officers, but they have great force.”²⁷⁶

When the application of the ultra vires doctrine started jeopardizing the security of land titles, among other problems, the accompanying concern contributed to a reform of the doctrine.²⁷⁷ Today, the influence of the ultra vires doctrine has been dramatically diminished to the point of near irrelevance.²⁷⁸ A similar concern may strengthen the case for de facto LLCs and torpedo the support for contrary positions.

4. Fitting Punishment

A fair system of justice should always strive to make the punishment fit the prohibited conduct or ensure that the recompense does not unduly exceed the loss.²⁷⁹ While it may accord with our notion of justice to impose personal liability for those who deliberately decide to ignore legal requirements for registration, such a response is out of proportion for those who exhibit slight sloppiness at some point in the registration process. “The de facto incorporation concept was invented as a fairness mechanism to mitigate the harshness that often resulted when unbeknownst to

officers and cannot be relied on by the officers to enforce a right incident to the office nor does it protect the officer from tort committed in the course of official acts. See Warren I, *supra* note 88, at 458. For a useful discussion of the foundation and limits of the de facto officer doctrine, see Charles W. Tooke, *De Facto Municipal Corporations Under Unconstitutional Statutes*, 37 YALE L.J. 935, 942-48 (1928).

276. Warren I, *supra* note 88, at 457.

277. RAGAZZO AND MOLL, *supra* note 42, at 297. See also Henry Winthrop Ballantine, *A Critical Survey of the Illinois Business Corporation Act*, 1 U. CHI. L. REV. 357, 381 (1934) (discussing the issue of the near demise of the doctrine and a particular case where a party who had received the benefits of a loan was able to use the defense to stop a corporation from realizing on the security for an ultra vires loan, effectively amounting to an unjust forfeiture).

278. See Stephen J. Leacock, *The Rise and Fall of the Ultra Vires Doctrine in United States, United Kingdom, and Commonwealth Caribbean Corporate Common Law: A Triumph of Experience Over Logic*, 5 DEPAUL BUS. & COM. L. J. 67 (2006) (surveying the legal position in several countries and discussing the decline of the ultra vires doctrine).

279. In the criminal context, this is encapsulated in the concept of proportionality. For interesting discussions of proportionality and retributive justice, see Morris J. Fish, *An Eye for an Eye: Proportionality as a Moral Principle of Punishment*, 28 OXFORD J. LEGAL STUD. 57, 69 (2008) (examining mandatory minimum sentencing and its effect on the proportionality of punishment); Rachel King, *No Due Process: How the Death Penalty Violates The Constitutional Rights of the Family Members of Death Row Prisoners*, 16 B.U. PUB. INT. L.J. 195, 221-225 (2007) (noting that the death penalty’s proportionality problems fail the goals of retributive justice); Dan Markel, *Retributive Damages: A Theory of Punitive Damages as Intermediate Sanction*, 94 CORNELL L. REV. 239, 318-320 (2009) (noting the comparative advantages of punitive damages in furthering the interests of retributive justice).

stockholders, their company failed to achieve de jure corporate status because one of the numerous, complicated requirements for incorporation prescribed by early corporation acts remained unsatisfied.²⁸⁰ Similar considerations of justice animate the corporation by estoppel doctrine.²⁸¹

Notwithstanding that the registration process has been greatly simplified, it remains a fact of life that errors are inadvertently made, as we continue to see in the incorporation and registration processes.²⁸² The de facto corporation concept still has a role in fulfilling its original mission of ensuring fairness and mitigating harsh punishment.²⁸³ The proposal here promotes justice by not overly punishing sloppy attention to detail.²⁸⁴ It also advances the notion and cause of justice by preventing third parties from using the lack of formal registration as a sword to escape liability after deriving benefits from the contract with the purported LLC.²⁸⁵

5. Risk Reduction

A related point is that a stringent approach that leaves no room for mistakes only escalates the risk of doing business in the LLC form. Contending that any remedy for doing business as an informal LLC should be imposed only on those knowingly evading the statute, Ribstein and Keatinge note that “[i]mposing strict or negligence-based liability on passive members who relied on others to make the filing increases the risk, and therefore the cost, of engaging in this form of business.”²⁸⁶ This situation is troubling, considering that the costs facing these investors “may outweigh any benefit to creditors from imposing this liability on innocent or merely unwary members, especially if the creditor was not misled by the failure to file.”²⁸⁷ A purporting-to-act provision that incorporates a knowledge component as proposed here will address the problem and ensure that more risk-averse and cautious investors are not driven away from the LLC business form. Considering that many of the defectively

280. Marc R. Lieberman, *The Happy Demise of Constructive Incorporation*, 22-Nov. ARIZ. B.J. 22, 22 (1986).

281. SMITH AND WILLIAMS, *supra* note 28, at 147 (stating that “the concepts of ‘de facto corporation’ and ‘corporation by estoppel’ were created by courts to deal with potential inequities that sometimes result from a failure to incorporate”).

282. *Supra* note 6 and accompanying text.

283. *See Breeze*, *supra* note 56, at 3 (stating that the de facto corporation doctrine originated from a recognition of the hardship that attended holding business associates personally liable when they have made a good faith attempt to limit their liability).

284. For a contrary view, see Waddoups, *supra* note 8, at 312.

285. *See Boslow Family Limited Partnership v. Glickenhau & Co.*, 7 N.Y.3d 664, 668 (N.Y. 2006) (making a similar point in the context of limited partnerships).

286. RIBSTEIN AND KEATINGE, *supra* note 17, at § 4: 15.

287. *Id.*

formed LLCs are likely to be small business outfits,²⁸⁸ and given the importance of small business to job creation and general economic growth,²⁸⁹ it will serve the society better to have a policy approach that does not drive entrepreneurs out of business by increasing the risk attendant upon organizing a business in this form.²⁹⁰

6. Windfall Profits

Writing in the corporate and limited partnership context, some scholars have made a forceful contention that no personal liability should attach to an investor where the creditor's negotiation was on the assumption that the other party was a corporation or had limited liability protection.²⁹¹ This position has provided a strong basis for arguing for the application of the de facto doctrine. According to one legal scholar, the rationale is anchored on the discomfort that stems from the import of imposing full personal liability on the business owners, that is, a windfall for the other party to the contract.²⁹² "As long as the creditor thought it was

288. The quest for a clear definition of the term "small business" has proven elusive. See Eyal-Cohen, *supra* note 4, at 6-7 (discussing the lack of a standard definition and listing various businesses that qualify as small business, including builders, mechanics, restaurants, retail stores, local laundry services, hairdressers, corner bakeries, auto dealerships, start-up companies and service firms).

289. See Scott Crist, *State's CAPCO Program Generates Follow-on Funds*, HOUS. CHRON. (May 22, 2009), at B11 (stating that "according to the United States Small Business Administration, small businesses have created 60 to 80 percent net new jobs in the U.S. over the past dozen years").

290. See Eyal-Cohen, *supra* note 4, at 4 ("Today, small firms employ half of the work force, generate almost all of the net new jobs, and produce 50% of the nation's GDP. They have adjusted to new economic conditions by developing market niches, and serving as intermediate suppliers to larger firms."); James W. Lovely, *Agency Costs, Liquidity, and the Limited Liability Company as an Alternative to the Close Corporation*, 21 STETSON L. REV. 377, 377 (1992) (discussing the role of small business enterprises in job creation, innovation and economic growth).

291. See Bradley, *supra* note 8, at 580 (urging the courts to give consideration to the parties intent and to stop awarding profits to plaintiffs that did not expect them when they were contracting). Discussing the issue in the limited partnership context, Professor Fessler observes that there are:

. . . two irreconcilable lines of judicial reasoning. One stresses the theme that limited partnerships are the creature of statutory law, and concludes that the benefit and protections of that association may be claimed only by those who have complied with the relevant statutes. The expectations of creditors are irrelevant since limited liability is not conferred by contract but results from a statutory status. The contrary authorities argue that creditor expectations, not abstract notions of public policy, should govern individual liability claims.

Daniel Fessler, *Alternatives to Incorporation for Persons in Quest of Profit* 229 (3d ed. 1991).

292. BAINBRIDGE, *supra* note 48, at 23.

dealing with a de jure corporation, the firm's defective incorporation is irrelevant. Personal liability would constitute a windfall the creditor did not expect and has done nothing to earn."²⁹³

The same argument has also provided justification for the application of the estoppel concept.²⁹⁴ In *Pharmaceutical Sales & Consulting Corp. v. J.W.S. Delavau Co.*,²⁹⁵ notwithstanding that there had been no application for a certificate of incorporation at the time of transaction, the court took the position that the business could sue as a corporation for breach of contract to prevent the defendant from escaping potential liability, amounting to "a windfall [that was not] expected at the time of the execution of the contract."²⁹⁶ This approach has a lot to commend it, particularly the fact that it "is premised upon the courts' desire to effectuate the parties' intent in entering into the contractual arrangement at issue."²⁹⁷

The windfall profits argument presents an attractive basis for applying the de facto and estoppel concepts, yet, the matter is much more complicated than that. The argument appears not to recognize that there are other interests involved in the issue of incorporation or registration. While the argument ensures that the court does justice between the parties, the court's duty goes beyond that narrow confine of ensuring a just outcome to include a commitment to applying existing law.²⁹⁸ The government also has an economic interest in ensuring that the benefit of limited liability is enjoyed only by those who have accepted the corresponding burden of payment of filing fees and franchise taxes to the state. Favoring compliance with statutory requirements is also a worthwhile governmental objective. Permitting those in non-compliance to be treated the same as those who have complied does not send a message that non-compliance is discouraged. In fact, some courts have clearly taken the stance that public policy encourages legal organization, and consequently are not willing to adopt a position that is inconsistent with

293. *Id.*

294. *See id.* at 24 (stating that courts developed the corporation by estoppel doctrine to deal with cases in which no good faith effort has been made to incorporate the business but "imposing full personal liability on the firm's would-be shareholders gives the other party to the transaction a windfall").

295. *Supra* note 52.

296. *Id.* at 407.

297. *Payer v. The SGL Carbon, LLC et al.*, No. 05-CV-0226E(F), 2006 WL 2714190 (W.D.N.Y. Sep. 22, 2006), at *5. *See also* *Bradley*, *supra* note 8, at 580 ("The Georgia courts should use this opportunity to put equitable considerations back into the application of this doctrine, to take the intent of the parties into consideration, and to stop providing windfalls to plaintiffs who sue defective corporations.").

298. *See* *Warren II*, *supra* note 88, at 313 ("If a court felt justified in taking note of nothing but the considerations of fairness between the parties to this particular suit, the argument might be allowed to prevail.").

this policy.²⁹⁹ Nevertheless, the question arises as to whether awarding windfall profits to the creditor is the most appropriate response to the problem.

One way of equitably and practically resolving the problem is to apply the de facto and estoppel concepts and thus eliminate windfall profits, but condition their application on an ex post imposition of the filing fee and applicable state taxes with interest. That way, creditors do not get undeserved profits, business owners receive protection for their personal assets and at the same time are deterred by a real prospect of a financial penalty, the government is made more than financially whole, and the society is assured that its interest in ensuring obedience to the law remains intact.

7. Prudential Policy-Making

The experience with corporations counsels a prudent approach that does not hastily abolish the defective registration concepts of de facto LLC and LLC by estoppel. Put succinctly, we need not repeat the mistake we saw with corporations in the case of LLCs. In light of that, one commentator made the following apt observation in discussing the pertinent portion of an LLC statute³⁰⁰ passed by Kansas in 1993 that provided for joint and several individual liability for those acting as an LLC prior to proper formation³⁰¹:

This ill-considered provision is a near-verbatim replica of section 146 of the original Model Business Corporation Act. It was intended to eliminate the case law doctrine of de facto corporations, at least when used by the stockholders of a defectively organized corporation as a defense to individual liability. This same section has also been held to repeal the related defense known as “corporation by estoppel.” Although the intent of section 146 may have been laudable, the lack of any explicit culpability requirement created the possibility that ruinous individual damages might be imposed on innocent, good faith investors in favor of third parties who in no way relied on such liability when dealing with the defective corporation and who were in no way caused harm by the defect in the corporation’s status. For this reason, the drafters of the Revised

299. *Lake State Fed. Credit Union v. Tretsven*, No. A07-1542, 2008 WL 2732111, at *3 (Minn. Ct. App. July 15, 2008). *See also* *Stone v. Jetmar*, 733 N.W.2d 480, 487 (Minn. Ct. App. 2007) (“Allowing a form of future interest to vest in unorganized entities would be inconsistent with our public policy of encouraging legal organization.”).

300. Kansas Limited Liability Company Act, KAN. STAT. ANN. § 17-7601-7652 (1993 Supp.) (repealed 2000).

301. *Id.* § 17-7621 (repealed 2000).

Model Business Corporation Act added the requirement that the defendants must know of the lack of incorporation before liability will be imposed. . . . [T]here seems little to recommend a rule that can impose individual liability on good faith, innocent investors who never agreed to such liability, and that can correspondingly grant windfall recoveries to third parties who never bargained for or expected such individual liability. . . .³⁰²

Based on the foregoing, the author therefore called for an amendment of the provision “to make it clear that the defendants must know they lack authority to act as an LLC before they can be held jointly and severally liable.”³⁰³ The Kansas statute was eventually amended to eliminate that irksome provision.³⁰⁴ It is along the same lines that this work calls for the amendment of every relevant statute in the country to reflect this sentiment.

B. Application of the Rule: A Taxonomy

The rule proposed here will apply in the following manner to the scenarios laid out below.

1. The lawyer’s oversight and purchase of land

A and *B* agreed on a joint enterprise for the production and marketing of children’s television programs. Upon their lawyer’s advice, they opt for an LLC as the most appropriate vehicle for accomplishing their professional and commercial objectives. They signed organization documents prepared by their lawyer, who mailed them to the relevant State agency. The lawyer mistakenly believed that one of the envelopes he recently received from the agency included a filed certificate of formation for this particular LLC and proceeded to inform the associates that their business has been registered. In reality, for some inexplicable reasons, the documents were not filed by the agency until one week later. Meanwhile two days after hearing from the lawyer, *B* signed an agreement to purchase a piece of land from *C* who, learning four months subsequently that the LLC was not formally organized at time of purchase and knowing that the value of the land has since appreciated considerably, wants to invalidate the transaction.

A de facto LLC came into existence. The associates made a colorable attempt to comply with the LLC statute and did not know of the lack of

302. Edwin W. Hecker Jr., *Limited Liability Companies in Kansas*, 63 J. KAN. B. ASS’N 40, 46 (1994) (citations omitted) (emphasis added).

303. *Id.*

304. Revised Limited Liability Act, KAN. STAT. ANN. § 17-7662 (2000).

formal organization. Thus, the de facto LLC can take and convey title to real estate. The vendor's claim will fail.

2. Supply of goods to the firm

Assuming that from the example in (1) above, *B* on behalf of the firm entered into a contract with *K* for the supply of goods to the firm for its operations during the period the associates thought the firm was formally organized. The goods were not fully paid for and *Y* seeks to hold the business owners personally liable.

K will not succeed. The firm is a de facto LLC that shields its members from personal liability.

3. Benefits from contract

X and *Y* signed a letter of intent to create an LLC. Each of them took certain steps toward operating the business, such as applying for a credit card, requesting an employer identification number and opening a bank account, but the LLC was never formed. Nevertheless, they operated the business as an LLC. The "LLC" opened a discretionary advisory account with Geniuses, Inc., an investment advisory firm. The "LLC" executed a discretionary investment advisory agreement giving Geniuses full discretion and authority to manage the advisory account. In exchange for managing the account, Geniuses received approximately \$85,000 in advisory fees over the course of the five years that the account remained open. Eventually, the "LLC" closed the account because it was not satisfied with the propriety of the investments made by Geniuses. Thereafter, the "LLC" brought a lawsuit against Geniuses seeking damages for breach of contract and negligence in managing the "LLC's" funds. Geniuses moved to dismiss the complaint asserting, among other things, that plaintiff failed to file its articles of organization and therefore was not a properly formed LLC; thus, it lacked the capacity to enter into the agreement and bring suit.

Although there is no de facto corporation, since the parties cannot show colorable compliance, the business is an LLC by estoppel. Having contracted with the firm on the basis that it was an LLC, the investment advisor cannot validly repudiate the contract on the claim that there was no validly organized LLC in existence. The fact that the advisor derived benefits under the contract further strengthens the case against it.

4. Goods received by the firm

If in the example (3) above, *H* supplied goods to the business, dealing

with the owners as an LLC. Later on, she turns around and seeks to hold the owners personally liable, contrary to the implied term of their contract that only the business is liable for obligations under the contract.

H will not succeed, based on LLC by estoppel.

5. Seeking to avoid state law

Assume also from example (3) above that there is a law in the state in which the “LLC” operates its business requiring all LLCs and some other business entities to comply with certain workplace safety standards. Some workers who took employment with the “LLC” on the belief that it was an LLC and thus under an obligation to assure their safety under the law, were injured while at work at the company’s business premises. The “LLC” has refused to pay the compensation mandated under the state’s safety law, arguing that since it has not filed articles of organization, it was not an LLC and therefore not covered by the statute.

The owners of the business represented the business as an LLC, on the basis of which the employees took the job. When a responsibility to pay compensation arose, the doctrine of LLC by estoppel will step in to stop the firm and its owners from simultaneously approbating and reprobating, taking advantage of the LLC form when it suits them and abandoning the designation when it proves inconvenient.

6. Personally liable if specific regulatory standards forbid

Statute provides that a particular type of business, such as banking, can only be conducted by LLCs. *G & J* assume to act as an LLC without authority and thereafter seek to avoid personal liability.

G & J are personally liable.

7. Inactive investors

The directors of a Connecticut manufacturing corporation decided to organize an LLC in Massachusetts, and transfer to it the assets of the Connecticut corporation. They took steps to that end, but apparently they did not follow the Massachusetts statute. They effected the transfer and carried on business under the name of TransMac, LLC. The directors did this without the knowledge of *Z*, a stockholder who afterwards exchanged her shares in the corporation for membership units in the LLC, but never participated in the business. The plaintiff, who had discounted the corporation’s draft and had recovered forty-six percent, sued *Z* as a partner for the residue.

Since *Z* was a non-participating associate, it will be unfair to hold her

personally liable for the debts of the firm, when she had nothing to with its organization and ensuring that it properly followed requirements.³⁰⁵ Similarly, there should be limited liability protection for investors that contribute capital to an existing business on the understanding, based on a representation, that it was properly organized or protection should also be available to those investors who make a capital contribution with the express stipulation that funds should not be utilized until formal organization of business. Since the passive investors neither acted as an LLC nor knew it was not formally organized, they are shielded. This result makes sense, as one would be hard-pressed to present a fair basis for holding passive investors liable when it is clear they did not act, authorize others beforehand to act on their behalf or ratify their acts afterwards.³⁰⁶

With regard to obligations arising from tort, the de facto doctrine as presented in this work will avail defendants in tort suits. In essence, only members of an LLC who can show colorable compliance and absence of knowledge of lack of formal organization will be protected. Lack of colorable compliance, colorable compliance with knowledge, or LLC by estoppel shall not be acceptable defenses to claims brought by tort creditors.

C. Critiquing Proposal

It would be naïve to expect the present proposal to glide through without formidable challenge, especially considering the enormous change it advocates in the country's legislative landscape. Without doubt, there is a coterie of credible criticisms that deserve further scrutiny and impeachment, if the experience in the corporate context is any guide.

One criticism of the proposal focuses on perceived superfluity. It faces the crucial question of need for creating or resorting to new doctrines of de facto LLC and LLC by estoppel when existing theories will suffice to address the problems. More specifically, a pertinent question borders on the utility of the LLC by estoppel doctrine when the outcome in many cases

305. See *In re W. Bank Trust Co.*, 163 F. 713, 724 (N.D. Texas 1908) (“In my judgment, it would be harsh and unjust to declare stockholders who became such after the concern was organized, who had nothing whatever to do with the management of its affairs, who were absolutely innocent of any wrong doing in relation thereto, to be partners in the concern and to declare them personally liable in all its obligations, and this simply because they were stockholders and had accepted the dividends declared on their stock. The immediate and inevitable consequence of such a holding here would be to inflict ruin on those who have not deserved it.”).

306. Levinsohn, *supra* note 21, at 278 (“In order to make one man liable for the acts of others, he must either directly or indirectly participate in the acts while they are being done or must authorize or direct them to be done beforehand or ratify and approve them afterwards.”).

would be the same under principles of basic contract law, such as the principle of promissory estoppel under § 90 of the Restatement of the Law of Contracts.³⁰⁷ For instance, at least in the private party litigation involving only a party using the lack of formal formation of an LLC to “weasel out” of or excuse its contract performance, the current majority rule would seem settled with or without the specific LLC rescue doctrines.³⁰⁸

A direct response is that the proposed rescue doctrines, just as their counterparts in other business forms, go beyond the remedy that promissory estoppel affords.³⁰⁹ In *Cantor v. Sunshine Greenery*,³¹⁰ the plaintiff entered into a lease with a corporation that at the time of signing the lease had not come into existence. When the corporation repudiated the lease, the landlord sought to hold the president of the corporation personally liable, using the nonfiling of the incorporation documents at time of lease as basis. The court held that the plaintiff was estopped to make that assertion because it dealt with Sunshine Greenery as a corporation.³¹¹ Thus, although the plaintiff did not make any representations as to the corporate existence of Sunshine Greenery, the corporation by estoppel prevented the plaintiff from succeeding in the quest for personal liability of the defendant.³¹²

Moreover, where an unformed LLC seeks to enforce a contract to which it is a party, the lack of formal organization may be a ground for dismissal of the suit. In *Boslow Family Limited Partnership v. Glickenhau & Co.*,³¹³ where a limited partnership sued under a contract that was entered into before its formal formation, the defendant successfully moved the Supreme Court of New York to dismiss the complaint on the basis that the limited partnership had failed to file its certificate of limited partnership at the time of contract and prior to the commencement of the lawsuit.³¹⁴ The appellate division of the New York Supreme Court affirmed the decision.³¹⁵ It took the New York Court of Appeals, applying the LP by estoppel concept to reverse the decisions.³¹⁶

The proposal also faces criticism on the point that since the legislature

307. RESTATEMENT (SECOND) OF CONTRACTS §90 (1981).

308. I acknowledge the insight of Professor Holley on this point, for which I am grateful.

309. See 4 WILLISTON ON CONTRACTS § 8:5 (Richard A. Lord ed., 4th ed. 2009) (discussing promissory estoppel, its requirements and limitations).

310. *Cantor v. Sunshine Greenery, Inc.*, 398 A.2d 571 (N.J. Super. Ct. App. Div. 1979).

311. *Id.*

312. RAGAZZO & MOLL, *supra* note 42, at 292.

313. *Boslow Family Ltd. P'ship v. Glickenhau & Co.*, 860 N.E.2d 711 (N.Y. Dec. 14, 2006).

314. *Id.* at 712.

315. *Id.* at 712.

316. *Id.* at 712-13.

has specified conditions for recognizing a business as an LLC, consequent upon which its owners enjoy a limited liability and its transactions are given validity, it is of questionable constitutional propriety – an intrusion on separation of powers – for the courts to disregard the requisite conditions and grant the same treatment and benefits of formal organization to businesses that have not met the conditions.³¹⁷ This criticism, however, seems to overlook the fact that the courts have long exercised such powers outside the business law arena. “It may well be answered that it is not for the courts to create public officers any more than to create corporations [or LLCs]; and yet the doctrine of *de facto* public officers is well established.”³¹⁸ It would be a more profitable endeavor, it is submitted, to exert our efforts to deciphering and delineating where such judicial encroachments are justifiable on considerations of public policy.³¹⁹ Moreover, the legislature can give its blessing to the judicial approach a priori through the adoption of the kind of proposal presented here.

Another criticism is one that has been leveled at assume-to-act provisions, including those with a knowledge component. Writing in the corporate context, Professor Larry Ribstein laments that “the rule persists today by statute in many jurisdictions that those ‘assuming’ or ‘purporting’ to act in the name of a corporation that they know has not been formally incorporated are personally liable to creditors with whom they contract.”³²⁰ The scholar notes that the consequence of the rule has been “results that were surprising and clearly contrary to the expectations of both parties.”³²¹

A key weakness of Professor Ribstein’s criticism is that while he assails assume-to-act provisions that contain a “knowledge” component, he cites cases that were decided under a different legal regime (i.e. statutes without a scienter requirement) or that would have been decided differently by any court faithfully interpreting the provision proposed herein.³²² In a nutshell, the cases involve situations in which the defendants were not acting with knowledge of the lack of incorporation, which under the present proposal would have entitled them to exoneration. In one of the cases he cites,³²³ the court held defendants personally liable for a debt

317. See Warren I, *supra* note 87, at 468–69 (raising a similar point in the corporate context).

318. *Id.* at 469.

319. See *id.* (“The question therefore reduces itself at last to a question of judgment. Are there considerations of public policy so urgent as to make it proper for the courts to allow persons to assert the right to be a corporation even when, on a sound construction of the legislative enactments, they have no such right?”).

320. Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 121 (1991) [hereinafter Ribstein, *Limited Liability*] (citation omitted).

321. *Id.* at 121–22.

322. *Id.* at 122 n.184.

323. T.K. Distrib., Inc. v. Soldevere, 704 P.2d 280 (Ariz. Ct. App. 1985).

incurred during a short interval when the corporation's charter was revoked for failure to file an annual report and pay an applicable fee, even though neither party was aware of the revocation.³²⁴ In the second case cited,³²⁵ the court imposed personal liability notwithstanding the fact that both parties were under the belief that there was incorporation.³²⁶ Under the formulation in this article, absent other factors unconnected with "knowledge," defendants in both cases would not be held personally liable.³²⁷ Thus, courts are expected to adopt the same line of reasoning deployed by a Connecticut superior court when dealing with a case involving the State's version of the provision in a recent case.³²⁸ In that case, the defendant averred that he was unaware that there was no incorporation and the court held that since the plaintiff had "failed to prove the *knowing* aspect of the statute . . . , the defendant operated as an officer of a *de facto* corporation and is entitled to corporate protection."³²⁹

In fairness to Professor Ribstein, one cannot ignore the fact there could be isolated instances where the court misconstrues a purporting-to-act provision with a knowledge component to impose personal liability even in the absence of knowledge on the part of the defendant. For instance, the Supreme Court of Iowa recently construed,³³⁰ as imposing personal liability for transactions that occur in the absence of *de jure* incorporation, the Iowa Business Corporations Act's provision that "[a]ll persons purporting to act as or on behalf of a corporation, knowing there was *no incorporation under this Act*, are jointly and severally liable for all liabilities created while so acting."³³¹ This construction was clearly mistaken as the court appears to be confusing the law before and after the 1984 revision of the MBCA.³³² The court quoted the comment to section 2.04 of MBCA 1984 out of context and cited pre-1984 judicial authority to support its interpretation of a provision that came into place in 1984 as a change of the prior situation it was referencing.³³³

On the other side of the spectrum, the proposal may be criticized for watering down the accepted stipulation in many quarters that those who

324. *Id.*

325. *Thompson & Green Machinery Co., Inc. v. Music City Lumber Co.*, 683 S.W.2d 340 (Tenn. Ct. App. 1984).

326. *Id.*

327. *See also* Bradley, *supra* note 8, at 544 n.129 (opining that under the knowledge provision, "the result [in *Soldevere*] would presumably have been different").

328. *Gallagher v. Whitteaker*, No. PJRFSTCV075004857S, 2008 WL 344574, at *1 (Conn. Super. Ct. Jan. 11, 2008).

329. *Id.* at *1 (emphasis in original).

330. *Estate of Woodroffe*, 742 N.W.2d 94, 102 (Iowa 2007).

331. *Id.* at 103 (emphasis in original).

332. *Id.* at 103-04.

333. *Id.*

assume to act as a corporation or LLC without authority to do so are personally liable for any resulting obligations. By shielding not only those who so acted, but lacked knowledge of their lack of authority, but also those who knew of the lack of authority even where the third party did not possess such knowledge, the proposal's formulation of LLC by estoppel may be protecting equity investors at the expense of creditors. This is problematic in the case of innocent creditors, i.e., those who did not know of the lack of formal organization as opposed to those who knew but proceeded to deal with the entity as though it were validly organized.

While stating that it may be understandable and acceptable to accord limited liability status to business associates who enter into a contract with a third party, where neither party knows the business does not enjoy *de jure* or *de facto* status, Professor Merrick Dodd has argued forcefully that a different result should obtain where only the associates possessed such knowledge.³³⁴ In such situations, the associates knew of the lack of formal organization and chose deliberately to mislead the third party as to their true status. Professor Dodd acknowledges that limited liability may be an implied term of the contract and that it would be an uphill, if not an impossible, task for the third party to prove he has been injured by the misrepresentation. However, Dodd insists that such a contract should not be enforced.³³⁵ Noting that since the associates' claim to limited liability protection is not statutory but founded on an implied contract that is "based on the theory that the outsider who has accepted their fraudulent statement as the truth should be deemed bound by his ignorance," Professor Dodd "submitted that no such claim should be tolerated."³³⁶ One may concede that where associates misrepresent their business as an LLC, giving them immunity simply because a third party dealt with them as an LLC may sometimes provide them with an unjustified cover. Therefore, third party creditors should be able to hold them personally liable. However, it is submitted that the protection should not be denied unless the misrepresentation was material and the creditor was injured by it.³³⁷

However, there is no reason to assume that this is the case at all times or that, as some scholars claim, the entrepreneur "committed a fraud on the

334. Dodd, *supra* note 73, at 557.

335. *Id.* at 554, 557.

336. *Id.* at 557 (citation omitted).

337. See also Ribstein, *Limited Liability*, *supra* note 320, at 111 (citation omitted):

If a firm calls itself a "corporation" or a "limited partnership" creditors justifiably expect that the firm is subject to the provisions of a corporation statute, and that the firm has made a public filing containing certain basic information. Thus, it might be appropriate in this situation to refuse to enforce the limited liability contract on the grounds of material misrepresentation or nondisclosure. However, this result should obtain only if the misrepresentation was material and if the creditor was injured by it.

plaintiff” that warrants the full wrath of unlimited liability.³³⁸ One example may help to illustrate the point. A government agency that wants to support the state’s goal of raising revenue through formal registration of businesses restricts bidding for its contracts to such businesses. An entrepreneur, *X*, has extensive experience in the area of the particular project. *X* lost his job a month ago and decided to go into business on his own. He bids for the contract on behalf of his business, which at the moment was an unformed LLC, but never discloses the fact of a lack of formal registration. *X* could not register the LLC because of time constraints relating to the deadline for acceptance of bids. The bid is successful. *X* can execute the contract effectively without any harm to the agency. In fact, it may benefit the agency more than if the contract had gone to less experienced and effective hands whose only advantage is that they won the time race in completing registration of their business before the end of the bid process. A fortiori, in similar transactions involving only private parties, immunity from personal liability should prevail.

Creditor protection also forms the basis of another criticism. While registration confers the benefit of limited liability, it also carries with it the burden of disclosure. Some states require LLC organizers to disclose certain information in the articles of organization, including the number of membership units, the company’s registered address and state of organization.³³⁹ Disclosure serves a creditor-protection function, as a potential creditor is entitled to rely on the disclosed information in making a decision on whether or not to deal with a particular business outfit. Since this information disclosure may be pertinent to a prospective creditor’s decision-making and protection, extending limited liability only to those who have complied serves as a default mechanism for penalizing those who have not provided such information and the concomitant creditor protection, thus compelling them to provide it or risk personal liability.³⁴⁰ By affording limited liability protection to those operating without registration as an LLC, the proposal here could defeat the operation of this default mechanism and deprive creditors of a valuable protective tool.

One must admit that the criticism has some merit. LLC statutes may require articles of organization to disclose owner contributions to the company, which undoubtedly “have some bearing on creditor interests,”³⁴¹ thus providing fodder for the argument against extending limited liability

338. Timothy R. Wyatt, *The Doctrine of Defective Incorporation and its Tenuous Coexistence with the Model Business Corporation Act*, 44 WAKE FOREST L. REV. 833, 873-74 (2009).

339. CALLISON & SULLIVAN, LLCs, *supra* note 140.

340. For a presentation and discussion of this criticism in the corporate context, and counter-arguments thereto, see Ribstein, *Limited Liability*, *supra* note 320, at 110.

341. *Id.* (citation omitted).

protection to those who have not made such disclosure in a filed public document.³⁴² On the other hand, it has been demonstrated that creditor-protection provisions based on “legal capital” are not as effective as they appear in accomplishing their objective of limiting distribution of assets to owners, as they have fallen prey to extensive manipulation.³⁴³ Creditors have also devised alternative, more effective means of protecting themselves in dealing with limited liability entities.³⁴⁴ In addition, the criticism would have been more forceful if all or most of the required disclosures pertained to creditor protection, but that is obviously not the case.³⁴⁵ For instance, the disclosure of total membership interests – analogous to disclosure of authorized shares – is not meant for protection of creditors, but instead aims at protecting LLC members from future dilution of their ownership interests.³⁴⁶

Also, the disclosures are of no import to tort victims of registered companies, thus placing tort victims of registered LLCs and de facto LLCs on the same footing if personal investor liability is also denied in the latter case.³⁴⁷ Further, creditors can demand the relevant information from investors and if it is not provided, adjust their cost of credit accordingly.³⁴⁸ In any case, as important as this criticism is, it does not provide sufficient justification for punishing a good number of innocent investors who had no knowledge that their business has not been properly organized under the relevant LLC statute. A question posed almost a century ago, based on a valid observation that mirrors current experience, still resonates and has relevance today:

The courts have been exceedingly solicitous to protect creditors who, as experience has shown, are usually alert to guard themselves from imposition. Should there not be a disposition to give more adequate protection to the unwary investor in stocks who, more frequently than the creditor, is the victim of imposition and fraud, and who stands in need of greater protection?³⁴⁹

The proposal may also be assailed for fostering an anti-competitive environment. Levying the charge in the corporate context, Professor

342. For a contrary position, see BAYLESS MANNING & JAMES J. HANKS JR., *LEGAL CAPITAL* 50-57 (3d ed. 1990).

343. *Id.*; Ribstein, *Limited Liability*, *supra* note 320, at 109.

344. MANNING & HANKS, *supra* note 342. *See also* Carpenter, *supra* note 86, at 425 (stating that experience has shown that creditors “are usually alert to guard themselves from imposition”).

345. *See* Ribstein, *Limited Liability*, *supra* note 320, at 110.

346. *Id.*

347. *Id.* at 127.

348. *Id.* at 110.

349. Carpenter, *supra* note 86, at 425 (citation omitted).

Ribstein notes that purporting-to-act “provisions have an anti-competitive effect in that they help preserve the states’ monopoly over corporate terms by preventing competition by private ordering alternatives. Those who seek corporate features, particularly including limited liability, must pay franchise taxes and deal with state legislators for changes in the statutes.”³⁵⁰

A similar point has been raised by Professor William Carney who notes that “[c]orporate laws also contain provisions that can be read broadly to preclude the use of other means to limit liability, by providing that persons who purport to act as a corporation, where none has been created, are jointly and severally liable for the enterprise’s obligations.”³⁵¹

My first response is that the proposal does not create a bar to contracts by creditors and equity investors to clothe the latter with limited liability. It is perfectly within the province and power of a party to many kinds of business transactions to agree beforehand not to hold the other party personally liable for obligations under the contract.³⁵² Prime examples are nonrecourse contracts³⁵³ that have been widely utilized in recent times by litigation finance companies.³⁵⁴ While in the past, there might have been difficulties in enforcing such or similar contracts, today’s courts are amenable to enforcing them.³⁵⁵ Professor Ribstein’s concerns presumably

350. Ribstein, *Limited Liability*, *supra* note 320, at 123-124.

351. William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 876 (1995).

352. See Levinsohn, *supra* note 21, at 287 (stating that “the courts from early times have upheld contracts limiting liability by appropriate stipulation, even in the case of common carriers”).

353. See Mitchell F. Crusto, *Extending the Veil to Solo Entrepreneurs: A Limited Liability Sole Proprietorship Act (LLSP)*, 2001 COLUM. BUS. L. REV. 381, 427 (2001) (stating that “in a nonrecourse contract, a creditor voluntarily contracts to look to the business assets and not the personal assets of the business owner for recourse should the loan default”) (citation omitted). A limitation of nonrecourse contracts as a liability limiting device, however, is that its availability is limited to voluntary, and not involuntary, creditors. *See id.* at 428.

354. See Myron C. Grauer, *Justice O’Connor’s Approach to Tax Cases: Could She Have Led the Court Toward A More Collaborative Role For the Judiciary in the Development of Tax Law?*, 39 ARIZ. ST. L.J. 69, 78 (2007) (describing a non-recourse loan as a loan for which the borrower bears no responsibility for its repayment beyond the borrower’s interest in the property used in securing the loan). For a discussion of non-recourse finance in the litigation funding area, see Eileen Libby, *Whose Lawsuit Is It?: Ethics Opinions Express Mixed Attitudes About Litigation Funding Arrangements*, 89 A.B.A. J. 36 (2003) (stating that litigation funding companies offer non-recourse finance, “meaning that if the case loses at trial or is overturned on appeal, the client is not obligated to reimburse the funder”); Julia H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, 31 VT. L. REV. 615 (2007); Mariel Rodak, *It’s About Time: A Systems Thinking Analysis of the Litigation Finance Industry and Its Effect on Settlement*, 155 U. PA. L. REV. 503, 506-07 (2006) (stating that with non-recourse financing, “if the plaintiff ultimately loses her case at trial she has no obligation to repay the amount advanced, and the [finance] company thus forfeits its entire investment”) (citation omitted).

355. Ribstein, *Limited Liability*, *supra* note 320, at 112-13 nn.139-142 and

stem from the fact that individuals could not contract within themselves to confer limited liability upon themselves and make the contract binding on non-parties when they do not have a privilege from the state to do so.³⁵⁶ While a reasoned argument can be made that third parties contracting with the enterprise can decide for themselves if they want to be bound by the limited liability agreement entered into by the entrepreneurs, it does not seem that allowing the state to exercise a monopoly in this fashion is necessarily an egregious delegation of power.³⁵⁷

Finally, the proposal may also be disfavored by those who would view it as encouraging indolence and rewarding irresponsibility. Writing about the Utah Business Corporation Act and the elimination of de facto corporations in that state, one commentator restated that “the requirements are straightforward and easy to satisfy. Negligent or ignorant individuals should not be shielded from the effects of their actions or bargains if they have not acted with sufficient care to meet with the requirements of the statute.”³⁵⁸ Nevertheless, I maintain that even the less diligent, who made effort but somehow failed in their bid to attend to every detail in the

accompanying text.

356. See e.g., *Wells v. Mackay Telegraph-Cable Co.*, 239 S.W. 1001, 1007 (Tex. Civ. App. 1921) where the court stated:

The public in its dealings with such business organizations has a right to the protection afforded them by our statutes regulating the formation of corporations. This protection would be greatly lessened if it should be held that by declaring and recording a declaration of trust persons can associate themselves together for business purposes, giving their organization all the powers of a corporation and limiting their individual liability, without complying with statutes which require proof of funds or assets of such an association before a charter will be granted it to conduct its business.

Id. See also *Thompson v. Schmitt*, 274 S.W. 554, 559-60 (Tex. 1925) (holding that only the limited partnership acts provide the means of obtaining limited liability outside the corporate form). This “judicial and legislative hostility” to attempts to enjoy corporate attributes, including limited liability by non-corporate groups is believed, among other reasons, to have precipitated the demise of the joint stock company. *Carney*, *supra* note 351, at 876.

357. For the argument that the contrary position, i.e., assumption of corporate privileges by non-corporate forms was against public policy, see EDWARD H. WARREN, *CORPORATE ADVANTAGES WITHOUT INCORPORATION* 398-404 (1929). See also *Breeze*, *supra* note 56, at 3 (“It follows that no association of individuals organized to engage in a business enterprise by any act or declaration not in pursuance of the enabling statute can divest itself of the character of a partnership and clothe itself with that of a corporation.”) (citation omitted). See also *Carney*, *supra* note 351, at 876 (highlighting the claim by another scholar that “the essence of corporate status – limited liability for investors – should only be obtainable upon terms prescribed by the legislature for protection of creditors, and upon payment of whatever revenues the state demands, thus revealing the statist basis for arguments against private limitations of liability”) (citation omitted).

358. *Waddoups*, *supra* note 8, at 312 (citation omitted).

formation process, deserve a second chance in the halls of equity.³⁵⁹

VI. CONCLUSION

Some scholars have raised, and impeached, some of the arguments for not recognizing de facto LLCs and LLCs by estoppel. First, where there has been a misrepresentation of the existence of a limited liability company, a credible argument can be made for providing legal recourse to misled or injured creditors against the investors personally.³⁶⁰ On the other hand, those creditors whose expectations were not extinguished or altered have suffered no injury and should not be provided rights or remedies beyond their bargain.³⁶¹ Further, the major goal of imposing personal liability for preformation contracts is to ensure compliance with statutory provisions and thereby obviate a situation where injured creditors are left without effective recourse because no firm assets are available and the whereabouts of the organizers may not be known.³⁶² In addition, not clothing investors with limited liability in all cases where they enter into transactions prior to compliance with statutory formation assures that states do not lose registration fees and franchise tax revenues, which otherwise would have been the case.³⁶³

The central argument of this work, based on a close examination of the arguments in favor and against, is that the de facto and estoppel concepts should be recognized in the LLC context. However, the protection should be limited only to cases when investors, in good faith, believe that a limited liability company had been formed or where the parties' transaction was conducted on the basis that an LLC is a party. This approach will simplify the application of the concepts while ensuring justice and fairness. The principal objective of this article, therefore, is the articulation of a case for states with a different approach or no clear approach to amend their LLC statutes accordingly.

359. See also BISHOP & KLEINBERGER, *supra* note 16, at ¶ 6.02[2][d][iii] (referencing the views of some authorities that “ease of organization is no reason to penalize entrepreneurs over technicalities”).

360. RIBSTEIN & KEATINGE, *supra* note 17, § 4:15.

361. *Id.*

362. *Id.*

363. *Id.*