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## Limited Liability Companies: The Optimal Business Organization for the Twenty-First Century?

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# LIMITED LIABILITY COMPANIES: THE OPTIMAL BUSINESS ORGANIZATION FOR THE TWENTY-FIRST CENTURY?

The limited liability company ("LLC") is one of the most significant recent developments relating to business organizations.<sup>1</sup> The LLC is an unincorporated organization that combines the limited liability feature of a corporation with the pass-through tax advantages and flexibility of a partnership.<sup>2</sup> Although similar characteristics may be found in the Subchapter S corporation ("S corporation") and the limited partnership,<sup>3</sup> the LLC offers significant advantages over both of these alternatives.<sup>4</sup> For example, while a limited partnership must have at least one general partner liable for the partnership's debts and generally may not have limited partners participating in management, an LLC allows active participation in the management of the business by all owners with-

<sup>1</sup> See Mark A. Sargent, *Are Limited Liability Interests Securities?*, 19 PEPP. L. REV. 1069, 1069 (1992). "The limited liability company . . . is one of the most interesting forms of business organization developed in recent years." *Id.*

<sup>2</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360 (classifying Wyoming LLC as partnership for tax purposes); see also Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 379-80 (1992). "LLCs are non-corporate entities under which neither the owners (known as members) nor those managing the business are personally liable for the LLC's obligations. [Moreover,] a properly structured LLC will be treated as a pass-through entity for federal income tax purposes." *Id.* Although the LLC is a unique entity, "the concept of a corporation-partnership hybrid is not a new idea." See Joseph A. Rodriguez, *Wyoming Limited Liability Companies: Limited Liability and Taxation Concerns in Other Jurisdictions*, 27 LAND & WATER L. REV. 539, 540 (1992). In fact, the predecessor to the LLC dates all the way back to the last half of the nineteenth century when Pennsylvania, Michigan, New Jersey, and Ohio enacted statutes providing for the creation of partnership associations. *Id.* As one commentator has noted:

Partnership associations . . . are unincorporated organizations wherein the owners, known as associates, are not personally liable for the obligations of the organization. At various times, the . . . [IRS] has treated partnership associations as either partnerships or corporations for tax purposes. [However,] [b]ecause many states have failed to adopt statutes recognizing partnership associations, this form of business entity has not attained great popularity.

Keatinge et al., *supra*, at 381-82.

<sup>3</sup> See Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083, 1103 (1992). "Before the enactment of the LLC legislation, investors who wished to achieve both limited liability and pass-through taxation would form either an S corporation or a limited partnership." *Id.*

<sup>4</sup> See Marybeth Bosko, *The Best of Both Worlds: The Limited Liability Company*, 54 OHIO ST. L.J. 175, 194 (1993). "Overall, the LLC has obvious advantages over the S [corporation] and it is likely that the latter will pose no serious threat to the development of the LLC." *Id.*

out sacrificing the protection of limited liability.<sup>5</sup> Similarly, LLCs can avoid application of many of the restrictive S corporation rules, thus providing business planners with greater flexibility in structuring management and financial arrangements.<sup>6</sup>

<sup>5</sup> See Kalinka, *supra* note 3, at 1103. "[A]n LLC offers structural advantages that investors cannot achieve by forming a limited partnership." *Id.* Although taxed in the same manner as an LLC, the general partners of a limited partnership are fully liable for the debts and obligations of the business. See REV. UNIF. LTD. PARTNERSHIP ACT § 403(b) (1985) [hereinafter RULPA]; see also Bart J. Colli & Debra S. Groisser, *10 Points of Light on Limited Liability Companies*, 135 N.J. L.J. 1035, 1035 (1993). On the other hand, limited partners in a limited partnership are not personally liable for the debts and obligations of the partnership, but in order to achieve this treatment they are required to be passive investors. *Id.* If a limited partner actively participates in the management of the business, he or she may stand to lose the protection of limited liability and become personally liable on some or all of the debts of the partnership. See RULPA § 303(a) (1985). This provision provides in relevant part:

[A] limited partner is not liable for the obligations of a limited partnership unless he [or she] participates in the control of the business. However, if the limited partner participates in the control of the business, he [or she] is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.

*Id.* By way of contrast, the LLC offers all its members limited personal liability while also permitting them to participate in the control of the business without the risk of forfeiting this limitation on liability. See Colli & Groisser, *supra*, at 1035; see also Keatinge et al., *supra* note 2, at 397. "The [control] rule has no place in an LLC, since, in the absence of personal guarantees, creditors do not rely on the managers' personal liability." *Id.*

<sup>6</sup> See I.R.C. §§ 1361-1378 (1988) (providing rules for S corporation); see also Brian L. Schorr & Aileen R. Leventon, *Limited Liability Company: An Alternative Business Form*, N.Y. L.J., May 30, 1991, at 1, 7. "The LLC is . . . not subject to certain restrictive S corporation rules, including election procedures and the taxation of built-in gains and passive income." *Id.* The S corporation is similar to the LLC in that it can effectively achieve limited liability in addition to the advantage of federal taxation as a partnership. See I.R.C. §§ 1361-1378 (1988). Nevertheless, there are several significant restrictions imposed on the S corporation which the LLC is not subject to. See I.R.C. § 1361(b)(1)(D) (1988). For instance, an S corporation may issue only one class of stock. *Id.* In contrast, an LLC can have any capital structure desired, making it possible, among other things, for groups of members to have different economic interests, and consequently, different rights to share in profits and losses. Furthermore, an S corporation is not permitted to have more than thirty five shareholders, while an LLC may be composed of an unlimited number of members. See I.R.C. § 1361(b)(1)(A) (1988); see also Bosko, *supra* note 4, at 193 (suggesting that this allows LLCs to expand into larger, perhaps more efficient, interstate companies and to engage in business ventures that require great deal of capital). Also, there is always the risk that the Subchapter S election can be revoked or lost, thus subjecting a corporation to standard corporate taxation under Subchapter C. See I.R.C. § 1362(d) (1988). The LLC's characteristic of limited liability is not conceived through an election, and therefore, is not subject to the same degree of risk. See Bosko, *supra* note 4, at 193. Moreover, an S corporation may not own eighty percent or more of the stock of another corporation. See I.R.C. § 1361(b)(2) (1988). An LLC, on the other hand, has no such restriction, thus making it easier for an LLC to participate in parent-subsidiary structures. See Colli & Groisser, *supra* note 5, at 1056. Finally, the shareholders in an S corporation may only be United States citizens or resident aliens, whereas LLCs have no such restriction. See I.R.C. § 1361(b)(1)(C) (1988).

With respect to tax related considerations, shareholders in an S corporation may only write off depreciation losses and other deductions to the extent of their basis in the S corporation stock. See I.R.C. § 1366(d) (1988). By comparison, members of an LLC will be able to adjust their tax basis to reflect their respective shares of LLC liabilities, thereby enhancing loss pass-throughs and minimizing gain recognition upon cash distributions. See John E. Davidian, *Opportunities and Pitfalls in Partnership Formations*, in 1 N.Y.U. PROC. FIFTY-

Like the shareholders of a corporation, the members of an LLC are not liable for the debts or obligations of the organization beyond the amount of their investment.<sup>7</sup> This is the protection afforded by the highly valued characteristic of limited liability. Moreover, as an unincorporated business form, the LLC can effectively avoid double taxation and achieve pass-through tax treatment for federal income tax purposes.<sup>8</sup> Pass-through entities such as LLCs, general partnerships, limited partnerships, and S corporations are not subject to federal income tax at the entity level.<sup>9</sup> Rather, these business organizations pass-through income, credits, and deductions to its owners who are then taxed on their respective shares of income, as apportioned.<sup>10</sup> In contrast, taxation of a C corporation<sup>11</sup> subjects the shareholders of the corporation to double taxation: the profits of the corporation are taxed once at the corporate level and then again upon distribution to the shareholders as dividends.<sup>12</sup> Thus, if a business operates as a corporation, it will typically receive less favorable tax treatment than if it operates as an LLC.<sup>13</sup>

FIRST INST. ON FED. TAX'N 9-1, 9-4 (1993). Further, there is generally no gain recognition on the distribution of appreciated property of an LLC, but there is recognition of gain on such a distribution from an S corporation. See I.R.C. § 311 (1988); see also Kalinka, *supra* note 3, at 1107 (noting that distributions of appreciated property cause greater tax liability for S corporation than for LLC).

<sup>7</sup> See Brian L. Schorr, *Limited Liability Companies: Features and Uses*, C.P.A. J., Dec. 1992, at 30. "One of the most important features of an LLC is that, like shareholders of a corporation, its members are not liable for obligations of an LLC beyond their investments." *Id.*

<sup>8</sup> See Sargent, *supra* note 1, at 1073. As a noncorporation, the LLC can also avoid application of the various legal capital provisions in corporation statutes which govern the corporate financial structure. *Id.* This provides the members of an LLC with a significant amount of flexibility in structuring financial arrangements. *Id.*

<sup>9</sup> See I.R.C. §§ 701, 1363(a) (1988); see also Keatinge et al., *supra* note 2, at 380.

<sup>10</sup> See Keatinge et al., *supra* note 2, at 380.

<sup>11</sup> See Joseph P. Fonfara & Corey R. McCool, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership?*, 23 LAND & WATER L. REV. 523, 523 n.5 (1988). The letters S and C pertain to the tax status of a corporation. *Id.* More specifically, an S corporation will avoid the double taxation that is imposed on a C Corporation. See I.R.C. § 1363(a) (1988).

<sup>12</sup> See Ernest A. Seemann, *The Florida Limited Liability Company: A New Form of Business Association*, 57 FLA. B.J. 536, 536 (1983); see also Mary Elizabeth Matthews, *The Arkansas Limited Liability Company: A New Business Entity Is Born*, 46 ARK. L. REV. 791, 792 (1994). Corporate profits are subject to federal income tax pursuant to I.R.C. § 11 (1988). *Id.* at 792 n.4. Amounts distributed to shareholders as dividends are then taxed at individual rates pursuant to I.R.C. § 61(a)(7) (1988). *Id.*

<sup>13</sup> See Kalinka, *supra* note 3, at 1084-85.

Currently, thirty-six states have passed LLC statutes,<sup>14</sup> including Delaware,<sup>15</sup> New Jersey,<sup>16</sup> and Connecticut,<sup>17</sup> and several other states are considering such legislation.<sup>18</sup> Furthermore, the American Bar Association has appointed two subcommittees to study LLCs and the National Conference of Commissioners on Uniform State Laws is drafting a uniform act for adoption by the states.<sup>19</sup>

This note provides an introduction to the basic business and tax aspects of the LLC. Part One traces the historical development of the LLC with special emphasis on the revenue considerations that New York must address in adopting its own statute. Part Two examines the test used by the IRS for classifying organizations as corporations or partnerships for federal income tax purposes and then focuses on how this test applies to LLCs. Finally, Part Three explores the moral hazard of limited liability, the doctrine of piercing the LLC veil, and specific problems the LLC may encounter outside the state in which it is formed.

## I. EVOLUTION OF THE LLC IN THE UNITED STATES

The first state to enact an LLC statute was Wyoming, in 1977.<sup>20</sup> The Wyoming legislature enacted the statute in response to a demand for a business organization with a lower tax burden than a

<sup>14</sup> See, e.g., ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (West Supp. 1993); COLO. REV. STAT. §§ 7-80-101 to -913 (Supp. 1993); DEL. CODE ANN. tit. 6, §§ 18-101 to -1106 (Supp. 1992); FLA. STAT. ANN. §§ 608.401 to .514 (West 1993 & 1994); ILL. REV. STAT. ch. 805, §§ 180/1-1 to 60-1 (West Supp. 1993); IOWA CODE ANN. §§ 490A.100 to .1601 (West 1994); KAN. STAT. ANN. §§ 17-7601 to -7651 (Supp. 1992); LA. REV. STAT. ANN. §§ 12:1301 to -69 (West Supp. 1994); MD. CODE ANN., Corps. & Ass'ns §§ 4A-101 to -1103 (1993); MINN. STAT. ANN. §§ 322B.01 to .960 (West Supp. 1994); NEV. REV. STAT. ANN. §§ 86.011 to .571 (Michie 1994); OKLA. STAT. tit. 18, §§ 2000 to 2060 (Supp. 1993); R.I. GEN. LAWS §§ 7-16-1 to -75 (Supp. 1992); TEX. REV. CIV. STAT. ANN. art. 1528n, arts. 1.01 to 9.02 (West Supp. 1994); UTAH CODE ANN. §§ 48-2b-101 to -158 (1994); VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993); W. VA. CODE §§ 31-1A-1 to -69 (Supp. 1993); WYO. STAT. §§ 17-15-102 to -143 (1993). For a comprehensive discussion of all relevant state LLC statutes, see LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES *passim* (1992).

<sup>15</sup> DEL. CODE ANN. tit. 6, §§ 18-101 (Supp. 1992).

<sup>16</sup> 1993 N.J. Sess. Law Serv. 210 (West).

<sup>17</sup> 1993 Conn. Pub. Acts 93-267.

<sup>18</sup> See, e.g., S.B. 469, 1993-94 Sess. (California); S.B. 1543, 178th Sess. (1993) (Massachusetts); N.Y.S. 27, 215th Sess. (1993-94) (New York); S.B. 74, 120th Sess. (1993-94) (Ohio); H.B. 1719, 176th Sess. (1993-94) (Pennsylvania).

<sup>19</sup> See Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part One)*, 37 S.D. L. Rev. 44, 45-46 (1992); see also Schorr, *supra* note 7, at 26.

<sup>20</sup> WYO. STAT. § 17-15-101 to -136 (1989). Similar legislation was introduced in Alaska on April 8, 1975, but was voted down primarily because of tax concerns. See Rodriguez, *supra* note 2, at 544.

corporation, but with greater protection from liability than a limited partnership.<sup>21</sup> Wyoming businesses, however, did not generously embrace the LLC as an alternative business organization.<sup>22</sup> In fact, from the date of the statute's enactment in 1977, through 1988, only twenty-six LLCs were formed.<sup>23</sup> The slow growth in the formation of LLCs was primarily due to proposed regulations issued by the Internal Revenue Service ("IRS") on November 17, 1980, which would have denied partnership classification to any entity that did not have a member with personal liability, but did have associates and joint profit objectives.<sup>24</sup> However, due to strong criticism, the IRS subsequently withdrew the proposed regulations and formed a study project to determine whether an LLC should be classified as a partnership or a corporation for tax purposes.<sup>25</sup>

Following the IRS's withdrawal of the proposed regulations, Florida became the second state to enact LLC legislation, and in 1982, it passed the Florida Limited Liability Company Act.<sup>26</sup> The statute was essentially intended as a vehicle to lure additional capital into the state, thereby expanding Florida's economic base.<sup>27</sup> Specifically, Florida tried to attract foreign investors from Central and South America by providing a form of business organization similar to the *limitada*, a foreign business organization that, if properly structured, provides for partnership tax treat-

<sup>21</sup> See Fonfara & McCool, *supra* note 11, at 523-24; see also Phillip P. Whynott, *North American Trade Treaty Stimulates Interest In U.S. LLCs: A Historical Update*, 1 Limited Liability Company Rep. 93-106 to 93-107 (Jan.-Feb. 1993). The Wyoming Act was a result of the direct efforts of Hamilton Brothers Oil Company, a company which was involved in international oil and gas exploration through Panamanian limited liability companies in the early 1970's. *Id.* In the mid 1970's, Hamilton decided to try to get a similar entity created in the United States which would provide flexibility from a business standpoint and retain the favorable characteristics of pass-through tax treatment and limited liability. *Id.* With the help of Peat, Marwick, Mitchell & Co. in Dallas, Texas, Hamilton drafted legislation which was presented to, and eventually adopted by, the Wyoming Legislature. *Id.*

<sup>22</sup> See Fonfara & McCool, *supra* note 11, at 523.

<sup>23</sup> *Id.*

<sup>24</sup> Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,709 (1980); see also Keatinge et al., *supra* note 2, at 383.

<sup>25</sup> See I.R.S. News Release IR-82-145 (Dec. 16, 1982). The IRS announced that the proposed regulations would be withdrawn and indicated that it would "undertake a study of the rules for classification of entities for federal tax purposes with special focus on the significance of limited liability." *Id.*; see also Keatinge et al., *supra* note 2, at 383.

<sup>26</sup> FLA. STAT. ANN. § 608.401 to .514 (West 1993 & Supp. 1994).

<sup>27</sup> See Richard Johnson, Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387, 387 (1983).

ment as well as limited liability.<sup>28</sup> However, as a result of the remaining uncertainty as to how LLCs would be classified by the IRS for tax treatment, many Florida businesses were hesitant to venture into this unsettled area.<sup>29</sup> More significantly, as a result of the federal tax uncertainty, no other state enacted an LLC statute until 1990.<sup>30</sup>

Finally, in 1988, these barriers were practically eliminated when the IRS handed down Revenue Ruling 88-76.<sup>31</sup> In the ruling, the IRS concluded that an LLC organized pursuant to the Wyoming Limited Liability Company Act would be characterized as a partnership for federal income tax purposes.<sup>32</sup> With this increased assurance that an LLC could classify as a partnership for federal tax purposes and thereby avoid the double taxation im-

<sup>28</sup> See Bosko, *supra* note 4, at 178 n.18. Primarily concentrated in the Central American, South American, and Western European communities, the *limitada* is a foreign business organization that grants all members limited liability and can be structured as a partnership for federal income tax purposes. *Id.*; see also Priv. Ltr. Rul. 8,003,072 (Oct. 25, 1979) (classifying Brazilian *limitada* as partnership for tax purposes). However, this form of business has not been widely used in the United States "because of certain restrictions on the amount of capital and other restrictions which generally allow only natural persons to be members." See Susan Pace Hamill, *The Limited Liability Company: A Possible Choice For Doing Business?*, 41 FLA. L. REV. 721, 722 n.9 (1989). Moreover, some uncertainty exists as to whether courts would respect the limited liability feature of the *limitada* if it were sued in the United States. *Id.*

<sup>29</sup> See Johnson, *supra* note 27, at 388. As of April 1, 1983, one year after the enactment of the Florida LLC Act, only two LLCs had been organized. *Id.*

<sup>30</sup> See Keatinge et al., *supra* note 2, at 383-84.

<sup>31</sup> Rev. Rul. 88-76, 1988-2 C.B. 360; see also Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 390 (1991).

<sup>32</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360. The issue in this revenue ruling was whether a Wyoming LLC, none of whose members or designated managers were personally liable for any debts of the company, should be classified as a corporation or a partnership for federal tax purposes. *Id.* The LLC in question had twenty-five members, three of whom were designated managers. *Id.* In accordance with the Wyoming statute, neither the members nor the managers were liable for the debts, obligations, or liabilities of the LLC. *Id.* The members of the LLC could assign or transfer their respective interests in the LLC only upon the unanimous written consent of all the remaining members. *Id.* In the event that the remaining members failed to approve of the transfer, the assignee would receive only the right to share in the LLC's profits. *Id.* Moreover, the LLC would dissolve upon any of the following events: (1) the expiration of the period fixed for the LLC's duration; (2) the unanimous written consent of all of the LLC's members; or (3) the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member, unless the remaining members unanimously agreed to continue the business. *Id.* Based on these facts, the IRS reasoned that the LLC in question possessed the corporate characteristics of limited liability and centralized management, but lacked the characteristics of free transferability of interests and continuity of life. *Id.* Consequently, the IRS concluded that the LLC lacked a "preponderance" of the corporate characteristics, and therefore, should be classified as a partnership for federal tax purposes. *Id.* The IRS has issued similar rulings with respect to LLCs organized in Virginia (Rev. Rul. 93-5, December 24, 1992), Colorado (Rev. Rul. 93-6, December 24, 1992), Nevada (Rev. Rul. 93-30, April 19, 1993), Delaware (Rev. Rul. 93-38, May 24, 1993), Illinois (Rev. Rul. 93-49, July 19, 1993), West Virginia (Rev. Rul. 93-50, July 19, 1993), and Florida (Rev. Rul. 93-53, August 2, 1993).

posed on a corporation, interest in the LLC was restored.<sup>33</sup> Consequently, in 1990, Colorado<sup>34</sup> and Kansas<sup>35</sup> became the third and fourth states respectively to enact LLC statutes. Texas,<sup>36</sup> Nevada,<sup>37</sup> Utah,<sup>38</sup> and Virginia<sup>39</sup> followed in 1991, and many other states began work on similar legislation. By the end of 1992, eighteen states had passed legislation providing for the formation of LLCs.<sup>40</sup>

### A. *New York State Revenue Considerations*

In New York, LLC bills were introduced in both houses of the State Legislature in the spring of 1992.<sup>41</sup> However, because of certain revenue concerns, the New York Legislature recessed for the summer without taking any action on these bills.<sup>42</sup> The bills were again considered during the 1993 legislative session, and on July 7, 1993, the New York State Assembly showed the first sign of promise by passing the New York Limited Liability Company Law.<sup>43</sup> Nonetheless, the New York State Senate adjourned without taking any action on the legislation, thereby deferring consideration until the 1994 legislative session.<sup>44</sup> As of this writing, no legislation has been passed providing for the formation of LLCs in New York.

<sup>33</sup> See S. Brian Farmer & Louis A. Mezzullo, *The Virginia Limited Liability Company Act*, 25 U. RICH. L. REV. 789, 790 (1991).

<sup>34</sup> COLO. REV. STAT. ANN. § 7-80-101 to -913 (West Supp. 1993).

<sup>35</sup> KAN. STAT. ANN. § 17-7601 to -7650 (Supp. 1992).

<sup>36</sup> TEX. REV. CIV. STAT. ANN. art. 1528n, arts. 1.01 to 9.02 (West Supp. 1994).

<sup>37</sup> NEV. REV. STAT. ANN. § 86.011 to .571 (Michie Supp. 1994).

<sup>38</sup> UTAH CODE ANN. § 48-2b-101 to -157 (Supp. 1992).

<sup>39</sup> VA. CODE ANN. § 13.1-1000 to -1073 (Michie 1993).

<sup>40</sup> See *supra* note 14.

<sup>41</sup> See Schorr, *supra* note 7, at 26.

<sup>42</sup> *Id.* More particularly, the concern is that permitting the formation of LLCs in New York while taxing them as partnerships would lead to significant revenue loss. See *The Tax Treatment of Limited Liability Companies: Hearings Before the New York State Senate Comm. on Corporations, Authorities and Commissions*, 215th Sess. (1992) [hereinafter *Hearings*] (testimony of James W. Wetzler, Commissioner, State of New York Department of Taxation and Finance); see also Lee A. Sheppard, *The Dark Side of Limited Liability Companies*, 55 TAX NOTES 1441, 1443 (1992) (noting important question is whether state would lose revenue from permitting LLCs to be taxed as pass-through entities).

<sup>43</sup> See *New York Legislature Considers Limited Liability Company Law*, OMNI CORP. & RES. SERVICES INC., Autumn 1993, at 1 [hereinafter *Legislature Considers*]. The New York Limited Liability Company Law was to be effective as of January 1, 1994. See N.Y.S. 27 § 1403, 215th Sess. (1993-94).

<sup>44</sup> See *Legislature Considers*, *supra* note 43, at 1.



Revenue considerations have been the biggest obstacle to the passage of LLC legislation in New York.<sup>45</sup> The principal concern is that permitting LLCs in New York while taxing them as partnerships would be fiscally damaging to the State and City.<sup>46</sup> More specifically, the problem is that potentially significant revenue loss could come both from new businesses entering the State as LLCs rather than corporations and from corporations converting to LLCs.<sup>47</sup>

However, even assuming that some revenue loss would occur, part of it would be offset by the tax costs that corporations and their shareholders would have to pay upon conversion.<sup>48</sup> These tax costs include personal income tax from any gain on shareholder distributions in excess of the shareholder's basis in the corporation's stock, and a corporate level tax on capital gains from the step-up in basis of the corporation's assets to fair market value.<sup>49</sup> Additionally, an LLC law would provide New York businesses that are currently being organized outside of New York with the opportunity to organize within the State. Presumably, this would also have a positive effect on New York State income tax revenues. Further, existing partnerships and new businesses that otherwise would have been partnerships would likely become LLCs in order to take advantage of the limited liability and organizational flexibility.<sup>50</sup> This would result in an increase in filing

<sup>45</sup> See Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 819 n.33 (1992). The author states:

In some states, the major obstacle to adoption [of LLC legislation] has been an anticipated loss of revenue from various corporate taxes as new entities organize as LLCs rather than as corporations and as some existing corporations convert to LLCs. For example, both New York and New York City have separate taxes on S corporations. New York anticipates few new S corporations if it adopts LLC legislation and, therefore, it is in the process of deciding how to make up for the revenue that would be lost from fewer S corporations before adopting an LLC statute.

*Id.* (citations omitted).

<sup>46</sup> See *Hearings*, *supra* note 42.

<sup>47</sup> See Sheppard, *supra* note 42, at 1443. "The question of revenue loss can be subdivided into two questions: What is the revenue effect of corporate conversions to LLCs? What is the revenue effect of new businesses entering the state as LLCs rather than using some other form of doing business?" *Id.*

<sup>48</sup> See I.R.C. § 336 (1988); see also Schorr, *supra* note 7, at 33 (recognizing that Federal tax consequences of converting to LLC may be significant).

<sup>49</sup> See I.R.C. § 336 (1988).

<sup>50</sup> See Sargent, *supra* note 1, at 1070 (noting that LLC permits business planner great freedom to tailor governance and financial arrangements to owner's needs, while maintaining limited liability for owner); see also *Hearings*, *supra* note 42 (noting that with no entity-level tax, movement of partnerships to LLC status could be significant).

and associated fee revenue, also helping to offset any revenue loss that the State might incur.<sup>51</sup>

Nevertheless, despite the additional revenue generated by corporate conversions and filing fees, if LLCs are accorded partnership tax treatment for New York State tax purposes, long term net revenue loss could be substantial.<sup>52</sup> For instance, New York State currently earns approximately 98 million dollars per year from franchise taxes paid by S corporations.<sup>53</sup> Because partnerships are not subject to such a tax, LLCs classified as a partnership for New York State tax purposes would avoid this liability. Thus, if New York strictly follows the federal tax classification scheme, under which LLCs can achieve partnership status, this could result in a net revenue loss to the State.<sup>54</sup> New businesses that otherwise would have been organized as S corporations would likely become LLCs to, among other things, avoid the State franchise tax, thereby reducing the number of S corporations subject to the tax.<sup>55</sup> Moreover, certain existing S and C corporations would find

<sup>51</sup> See Bosko, *supra* note 4, at 196. "[E]ven if a state receives less corporate revenues due to the growth of the LLC, it should also realize an increase in the overall amount of revenue from partnership status entities, because the LLC Acts will attract business to the state." *Id.*

<sup>52</sup> See *Hearings*, *supra* note 42.

<sup>53</sup> Steve Zych, *Corporate Franchise Tax Collections General Business and S-Corporations For Fiscal Years 1989-1993*, State of New York Department of Taxation and Finance, Office of Tax Policy Analysis, Tax Data Bureau (Mar. 17, 1994) (on file with author). For the state fiscal year ending March 1992, New York State earned \$102,990,000 from franchise taxes imposed on S corporations. *Id.* For the state fiscal year ending March 1993, New York State earned \$93,268,000 from these franchise taxes. *Id.* Both New York State and New York City impose separate franchise taxes on S corporations. See N.Y. TAX LAW § 209 (McKinney 1986 & Supp. 1994); ADMIN. CODE OF THE CITY OF N.Y. tit. 11, § 11-603(1) (1986).

<sup>54</sup> See Rodriguez, *supra* note 2, at 559. The author notes:

If a state's tax laws are based upon federal tax laws, no state corporate tax will likely be imposed [on] the . . . LLC because the state will likely perform the same corporate characteristic analysis as did the IRS. Under such circumstances, the state is not likely to find a preponderance of corporate characteristics present in the . . . LLC if the IRS failed to do so.

*Id.*; see also Barbara C. Spudis, *Expanded Choice-of-Entity Considerations: Limited Liability Companies*, ALI-ABA, available in WESTLAW, Journals & Law Reviews Database. The author notes:

When a state imposes a franchise tax on corporations . . . , an issue arises as to whether such tax will be applied to LLCs. If the analogy to partnerships which applies with respect to federal and state income tax is followed, such tax should not apply to LLCs.

*Id.*

<sup>55</sup> See Schorr, *supra* note 7, at 30. "[T]he proposed [New York] legislation does not adopt complete federal conformity . . . for New York State tax purposes because of a concern that federal conformity could result in a net revenue loss if entities organize LLCs, thereby reducing the number of S corporations subject to tax in New York." *Id.*; see also Bosko, *supra* note 4, at 196. "The basic theory is that with more businesses registering as LLCs rather than corporations, the states' total tax revenues will decline." *Id.*

it financially beneficial to convert to LLC status.<sup>56</sup> By converting to LLCs, these organizations could maintain their limited liability, gain the advantage of greater organizational flexibility, and decrease their tax liability.<sup>57</sup> Consequently, if LLCs are not subject to some type of state entity-level tax or fee to compensate for the reduced number of S and C corporations, New York may be faced with a considerable decrease in the size of its corporate tax base.<sup>58</sup> In fact, the New York State Department of Taxation and Finance has estimated that taxing New York LLCs as partnerships could result in the State facing revenue losses of 60 to 80 million dollars annually, with the prospect that such losses would increase over time.<sup>59</sup> Accordingly, it is in New York's best interest to ensure that the final tax provisions of its LLC legislation result in a revenue neutral statute consistent with the fiscal circumstances in New York State.<sup>60</sup>

Two possible solutions may be considered in order to minimize or eliminate any potential revenue loss from the adoption of LLC legislation in New York.<sup>61</sup> The first option would be to impose a per-member fee on the LLC.<sup>62</sup> This proposal would treat LLCs in a manner similar to their tax treatment in many other states that have LLC statutes.<sup>63</sup> This approach is favorable because it is a relatively uncomplicated way of raising revenue.<sup>64</sup> From the State's perspective, however, a fee structure might not provide sufficient protection against possibly significant corporate income tax losses.<sup>65</sup>

The second option is to impose an entity-level tax on LLCs similar to the tax imposed on S corporations.<sup>66</sup> Some of the benefits

<sup>56</sup> See *Hearings*, *supra* note 42.

<sup>57</sup> See Sargent, *supra* note 1, at 1069 (noting LLC allows for greater freedom to tailor to members' needs while maintaining limited liability).

<sup>58</sup> See *Hearings*, *supra* note 42.

<sup>59</sup> *Id.*

<sup>60</sup> See Brian L. Schorr, *Limited Liability Companies: Features and Uses*, 805 PLI/Corp. 191 (1993), available in WESTLAW, Texts and Periodicals Database (recognizing that New York statute should be revenue neutral); see also Sheppard, *supra* note 42, at 1444 (same).

<sup>61</sup> See *Hearings*, *supra* note 42.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> See *Hearings*, *supra* note 42; see also Rodriguez, *supra* note 2, at 559. "[I]f the state does not follow the federal tax scheme, a corporate tax may be imposed upon the income derived from the business activities conducted within the host state." *Id.* State taxation on corporations falls generally into two categories: (1) taxes on net income derived from or attributable to the state; and (2) excise taxes on doing business, owning property or engag-

associated with such a tax are: (1) it would generate tax revenue; (2) it would virtually eliminate one of the largest incentives for S corporations to convert to LLC status; (3) certain advantages of the C corporation will be given greater value if there is a tax price connected with LLC status, therefore, some C corporations would not find it advantageous to switch business forms; and (4) new and existing partnerships that become LLCs would have to pay the entity-level taxes.<sup>67</sup> On the other hand, this option involves a "complexity cost" to both the taxpayers and the State.<sup>68</sup> LLCs would have to compute a taxable income for New York State purposes which is not required at the federal level.<sup>69</sup>

By adopting either one of these approaches, or a combination of the two, New York could minimize, if not eliminate, most of the serious revenue concerns associated with the adoption of an LLC statute. More importantly, the adoption of LLC legislation in New York would be a significant step in attracting new business to the State and in promoting New York as a competitive location for conducting and establishing business enterprises.<sup>70</sup> For decades, thousands of New York businesses have been organizing in the State of Delaware because of New York's failure to modernize its business laws.<sup>71</sup> As a result, franchise taxes and filing fees that otherwise would have accrued to the State of New York have subsidized the State of Delaware at the expense of New York taxpayers.<sup>72</sup> New York must begin to change the perception in the business community that it is either unwilling to meet the needs of

ing in other activities within the state. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES* ¶ 7.01 (2d ed. 1993). The tax on net income is commonly referred to as a "direct income tax," and the excise, as a "franchise tax." *Id.*

<sup>67</sup> See *Hearings*, *supra* note 42.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> See *Joint Public Hearing on Limited Liability Company Legislation: Before the New York State Assembly Standing Comm. on Judiciary and Assembly Standing Comm. on Corporations, Authorities & Commissions*, 215th Sess. (1992) (testimony of Brian L. Schorr).

<sup>71</sup> See Frederick Attea, *Wake Up Albany!*, N.Y. St. B.J., January 1994, at 44, 44 (noting that New York's failure to modernize its business laws and eliminate certain "archaic or anti-entrepreneurial provisions" has caused many businesses based in New York to organize in Delaware).

<sup>72</sup> *Id.* The author notes:

The bottom line is that many New York attorneys routinely refuse to form corporations under New York Law. The cost to New York . . . is millions upon millions. Who makes up those millions—New York taxpayers. New York's lack of sensitivity has helped Delaware meet its entire state budget by fees derived from incorporations of businesses that are based in New York.

*Id.*

business or is unaware of those needs.<sup>73</sup> The adoption of legislation authorizing the formation of LLCs would be a step in the right direction.

## II. FEDERAL INCOME TAXATION ISSUES

When evaluating the potential utility of the LLC as a business organization, it is essential to analyze how the IRS will classify and treat the entity for federal income tax purposes. Specifically, the issue is whether for federal tax purposes the LLC will be classified as a partnership or an association taxable as a corporation.<sup>74</sup>

Section 301.7701-2(a)(1) of the Treasury Regulations sets forth six characteristics that are ordinarily associated with a "pure corporation:" (1) associates; (2) an objective to carry on business and divide the gains therefrom; (3) continuity of life; (4) centralized management; (5) limited liability; and (6) free transferability of interests.<sup>75</sup> Whether a particular organization will be classified as an association or a partnership is determined by taking into account the presence or absence of each of these characteristics.<sup>76</sup> Thus, if an unincorporated business organization, such as the LLC, possesses more corporate than noncorporate characteristics, the IRS will classify the organization as an association and treat it as a corporation for federal income tax purposes.<sup>77</sup> However, since the characteristics of associates and an objective to carry on a business and divide the gains therefrom are generally common to both partnerships and corporations, the IRS does not consider these two characteristics in its determination.<sup>78</sup> Consequently, in order to secure partnership classification for federal tax purposes,

<sup>73</sup> *Id.*

<sup>74</sup> See Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993). The term "association" refers to an organization whose characteristics require it to be classified by the IRS, for tax purposes, as a corporation rather than another type of organization such as a partnership or trust. *Id.*

<sup>75</sup> See Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993). Whether an organization possesses or lacks these characteristics will depend upon the facts and circumstances in each individual case. *Id.* Furthermore, the IRS may consider other factors not listed in the Regulations in determining whether an organization will be classified as a corporation or a partnership. *Id.*

<sup>76</sup> *Id.*; see also Rev. Rul. 88-76, 1988-2 C.B. 360.

<sup>77</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360; see also *supra* notes 11-13 and accompanying text.

<sup>78</sup> *Id.* In interpreting § 301.7701-2 of the regulations, the Tax Court in *Larson v. Commissioner* 66 T.C. 159 (1976), concluded that equal weight must be accorded to each of the remaining four characteristics. *Id.* at 172.

a properly structured LLC should lack two of the remaining four corporate characteristics: limited liability; continuity of life; centralized management; and free transferability of interests.<sup>79</sup> The following four sections will examine these corporate characteristics and consider how each relates to the federal tax classification of the LLC.

### A. *Limited Liability*

One of the primary advantages of the LLC is the limited liability conferred upon all its members and managers.<sup>80</sup> The Treasury Regulations provide that an organization will have the corporate characteristic of limited liability if, under state law, there is no member who is personally liable for the debts of or claims against the organization.<sup>81</sup> A member is personally liable if "a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim."<sup>82</sup>

Presently, the IRS is considering whether LLCs can lack the characteristic of limited liability.<sup>83</sup> Although most LLC statutes provide limited liability to members and managers as a mandatory rule, the Texas and Virginia acts permit a member to waive limited liability.<sup>84</sup> Presumably, if such a waiver is made, limited liability will not exist and the members will be personally liable for the LLC's debts and obligations. However, since limited liability is one of the primary advantages of LLC status, the LLC will in all likelihood be structured to possess this corporate characteristic.<sup>85</sup> Business planners, therefore, will focus generally on

<sup>79</sup> See Keatinge et al., *supra* note 2, at 424.

<sup>80</sup> See *id.* at 385. "One of the primary functions of the LLC is to provide an alternative to the corporate form of obtaining limited liability." *Id.*

<sup>81</sup> See Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993); see also *Larson v. Commissioner*, 66 T.C. at 179. In *Larson*, the court held that "[u]nless some member is personally liable for debts of, and claims against, an entity . . . the entity possesses the corporate characteristic of limited liability." *Id.*

<sup>82</sup> Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993).

<sup>83</sup> See Mary L. Harmon, *Federal Income Tax Considerations for Limited Liability Companies*, 1993, available in WESTLAW, Texts and Periodicals Database, PLI File.

<sup>84</sup> See TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 4.03 (West 1994) (waiver of limited liability must be set forth in regulations); VA. CODE ANN. § 13.1-1019 (Michie 1993) (waiver of limited liability must be set forth in articles of organization).

<sup>85</sup> See Matthews, *supra* note 12, at 867 (noting that most LLCs will be structured to possess corporate characteristic of limited liability).

organizing the LLC to lack at least two of the remaining three corporate characteristics.<sup>86</sup>

### B. Continuity of Life

An organization has the corporate characteristic of continuity of life for federal income tax purposes if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization.<sup>87</sup> On the other hand, if state law provides that dissolution of the organization will occur upon the happening of any of these events then continuity of life will be lacking.<sup>88</sup> An LLC will lack the characteristic of continuity of life even though the remaining members can agree to continue the business after a dissolution event, if notwithstanding such agreement, any member has the power under state law to dissolve the organization.<sup>89</sup> Thus, there may be a dissolution of an LLC and no continuity of life although the business is continued by the remaining members.<sup>90</sup>

Although the IRS has recently clarified the regulations relating to the continuity of life rule, one of the principal issues that has not been resolved in this area is whether an LLC can avoid continuity of life if continuation of the business may be authorized by a majority in interest of the remaining members.<sup>91</sup> Under prior regulations, unanimous consent of all the members was apparently necessary to continue the business of the organization after a dissolution event in order to lack the corporate characteristic of continuity of life.<sup>92</sup> Subsequently, however, the IRS amended the

<sup>86</sup> *Id.*

<sup>87</sup> See Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993). In this context, "dissolution of the organization means an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law." See Treas. Reg. § 301.7701-2(b)(2) (as amended in 1993).

<sup>88</sup> See Treas. Reg. § 301.7701-2(b) (as amended in 1993). A corporation possesses a greater degree of continuity of life than a partnership because its existence is not dependent upon personal events affecting its members. See *Larson v. Commissioner*, 66 T.C. 159, 173 (1976). Because of their close legal and financial relations, partners are accorded a continuing right to choose their associates. *Id.* With respect to corporate shareholders, this right is denied. *Id.*

<sup>89</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360 (providing that LLC formed under Wyoming Limited Liability Company Act which provided that business of company may be continued by consent of all members, lacks corporate characteristic of continuity of life).

<sup>90</sup> See Treas. Reg. § 301.7701-2(b)(2) (as amended in 1993).

<sup>91</sup> See Lawrence H. Brenman, *Limited Liability Companies Offer New Opportunities to Business Owners*, 10 J. PARTNERSHIP TAX'N 301, 305-06 (1994).

<sup>92</sup> See Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993) (noting that limited partnership which ceased to continue upon dissolution "unless remaining general partners . . . or

regulations to make it clear that requiring the consent of a majority in interest of the remaining members to continue the enterprise, rather than all the members, would not result in a limited partnership possessing continuity of life.<sup>93</sup> Although commentators have requested that the amended regulations be extended to LLCs, the IRS has not yet expressly done so.<sup>94</sup> However, several recent private letter rulings<sup>95</sup> suggest that the IRS is liberalizing its view with respect to the application of the continuity of life rule to LLCs.<sup>96</sup> For example, in Private Letter Ruling 93-33-032, the IRS considered how the amended regulations applied to an Illinois LLC.<sup>97</sup> The LLC's operating agreement provided that upon a dissolution event, the business of the LLC could be continued by the written approval of two-thirds of all remaining members, so long as they constituted a majority in interest of all remaining members.<sup>98</sup> The IRS concluded that under the amended regulations the LLC did not possess the characteristic of continuity of life, notwithstanding the fact that dissolution could be avoided, because at least a majority in interest of the remaining members was needed to continue the LLC following a dissolution event.<sup>99</sup>

While this letter ruling provides some indication as to how the IRS might treat an LLC in circumstances similar to those addressed in the ruling, it will not necessarily be dispositive in future IRS decisions.<sup>100</sup> Private letter rulings, issued by the IRS,

unless all remaining members agree to continue" lacks continuity of life); see also Kurtz, *supra* note 45, at 820 n.39.

<sup>93</sup> See Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993); see also Kurtz, *supra* note 45, at 820 n.39; John Cederberg, *Continuity of Life*, 1 *Limited Liability Company Rep.* 93-101 to 93-102 (Jan.-Feb. 1993).

<sup>94</sup> See 58 Fed. Reg. 28,501 (1993) (noting final regulations have not been amended in response to commentators' requests); see also Brenman, *supra* note 91, at 306. "Although practitioners requested the IRS to extend the May regulations to LLCs, it did not expressly do so." *Id.*

<sup>95</sup> See Priv. Ltr. Rul. 93-33-032 (May 24, 1993); Priv. Ltr. Rul. 93-31-010 (May 5, 1993); Priv. Ltr. Rul. 93-21-047 (Feb. 25, 1993). The IRS took the position in these three private letter rulings that majority consent continuation agreements did not cause an LLC to possess the characteristic of continuity of life.

<sup>96</sup> See Matthew W. Ray, *The Texas Limited Liability Company—A Possible Alternative for Business Formation*, 46 *SMU L. REV.* 841, 855 (1992). "Although the IRS traditionally has taken a strict approach to the unanimous consent requirement, recent private letter rulings suggest that it may be liberalizing its approach." *Id.*

<sup>97</sup> See Priv. Ltr. Rul. 93-33-032 (May 24, 1993). For an excellent discussion of the Illinois limited liability company, see Scott R. Anderson, *The Illinois Limited Liability Company: A Flexible Alternative for Business*, 25 *LOY. U. CHI. L.J.* 55, 69 (1993).

<sup>98</sup> See Priv. Ltr. Rul. 93-33-032 (May 24, 1993); see also Anderson, *supra* note 97, at 69.

<sup>99</sup> See Priv. Ltr. Rul. 93-33-032 (May 24, 1993).

<sup>100</sup> See Anderson, *supra* note 97, at 69-70 (noting that letter rulings do not necessarily govern future IRS determinations).



have no precedential value to any party other than the party who requested the ruling.<sup>101</sup> Nonetheless, when viewed together, the amended regulations and recent private letter rulings seem to indicate that the IRS has taken the position that LLCs may safely provide in their articles of organization or regulations that after a dissolution event, the business may continue with the consent of less than all remaining members, provided that the agreement requires the consent of at least a majority in interest of all remaining members.<sup>102</sup>

Additional questions associated with the continuity of life characteristic arise when an LLC can continue to exist after a dissolution event with anything less than the consent of a majority in interest of the remaining members. For instance, the Florida Limited Liability Company Act<sup>103</sup> permits the members of an LLC to provide in their articles of organization for a right to continue the business upon a dissolution event.<sup>104</sup> Under such a provision, an LLC would not dissolve upon a dissolution event, even though the members did not agree to continue the business.<sup>105</sup> In effect, the business of the LLC would continue automatically. Consequently, the IRS will likely conclude that an LLC possesses continuity of life if a right to continue is provided in its articles of organization or operating agreement.<sup>106</sup>

<sup>101</sup> See I.R.C. § 6110(j)(3) (1988); see also *David R. Webb Co. v. Commissioner*, 708 F.2d 1254, 1257 n.1 (7th Cir. 1983) (noting that private letter rulings may not be used or cited as precedent).

<sup>102</sup> See Anderson, *supra* note 97, at 70.

<sup>103</sup> FLA. STAT. ANN. § 608.401 to .514 (West 1993 & Supp. 1994).

<sup>104</sup> FLA. STAT. ANN. § 608.441 (West 1993 & Supp. 1994). The Florida statute provides in relevant part:

(1) A limited liability company organized under this chapter shall be dissolved upon the occurrence of any of the following events:

.....

(c) Upon the death, bankruptcy, or dissolution of a member or upon the occurrence of any other event which terminates the continued membership of a member in the limited liability company, unless the business of the limited liability company is continued by the consent of all the remaining members or under a right to continue stated in the articles of organization of the limited liability company.

*Id.*

<sup>105</sup> See Ray, *supra* note 96, at 856-57. As one commentator has noted, a statute that provides for a right to continue "allows the members [of an LLC] to circumvent the traditional automatic dissolution events by adding explicit provisions to the LLC's articles of organization or regulations." Keatinge et al., *supra* note 2, at 426.

<sup>106</sup> See Keatinge et al., *supra* note 2, at 425-26. "A right to continue the business in the articles of organization arguably causes the LLC to possess continuity of life because it deprives each member of the power to dissolve the LLC as a matter of law." *Id.*

### C. Centralization of Management

An organization possesses the corporate characteristic of centralized management if any person, or any group of persons which does not include all the members, has continuing exclusive authority to make the organization's management decisions.<sup>107</sup> The persons who have such authority may or may not be members of the organization and may be elected to office or selected through some other process.<sup>108</sup> Additionally, continuing exclusive authority to make management decisions does not exist unless the managers have sole authority to make such decisions.<sup>109</sup>

At present, it is somewhat unclear as to when an LLC will be recognized as having centralized management if only a portion of the members are chosen to be managers.<sup>110</sup> Specifically, the uncertainty flows from Revenue Ruling 88-76,<sup>111</sup> Revenue Proceeding 89-12,<sup>112</sup> and Revenue Ruling 93-6.<sup>113</sup>

Revenue Ruling 88-76 concerned a Wyoming LLC that was composed of twenty-five members, including three who were designated managers.<sup>114</sup> The IRS ruled, without much analysis, that because the management of the LLC was reserved to three se-

<sup>107</sup> See Treas. Reg. § 301.7701-2(c)(1) (as amended in 1993).

<sup>108</sup> See Treas. Reg. § 301.7701-2(c)(2) (as amended in 1993).

<sup>109</sup> See Treas. Reg. § 301.7701-2(c)(4) (as amended in 1993). In a corporation, management is generally centralized in the officers and directors. See *Larson v. Commissioner*, 66 T.C. 159, 176 (1976). The shareholders' involvement in the managerial operations is typically limited to the election of these representatives. *Id.* In contrast, managerial authority in a general partnership is decentralized, such that any partner has the power to make binding decisions in the ordinary course of business. *Id.*; see also UNIF. PARTNERSHIP ACT § 9(1) (1992). Section 9(1) provides:

Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

*Id.* With respect to a limited partnership, managerial authority exists only in the general partners, and a limited partner that takes part in the "control" of the business may lose his limited liability status. See *Larson v. Commissioner*, 66 T.C. at 176; see also RULPA § 303(a) (1985), *supra* note 5 and accompanying text.

<sup>110</sup> See Keatinge et al., *supra* note 2, at 429. "It is unclear whether a manager-managed LLC will be considered to have centralized management." *Id.* On the other hand, if the LLC vests management authority in all the members and the members do not designate managers, the LLC will lack the characteristics of centralized management. See Rev. Rul. 93-38, 1993-21 I.R.B. 4 (addressing Delaware LLC).

<sup>111</sup> Rev. Rul. 88-76, 1988-2 C.B. 360.

<sup>112</sup> Rev. Proc. 89-12, 1989-2 C.B. 798.

<sup>113</sup> Rev. Rul. 93-6, 1993-3 I.R.B. 8.

<sup>114</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360; see also *supra* note 32 (discussing particular facts of Revenue Ruling 88-76).

lected managers, the LLC possessed the corporate characteristic of centralized management.<sup>115</sup>

It is conceivable, however, that Revenue Ruling 88-76 will not be applicable to all LLCs with designated managers.<sup>116</sup> The Treasury Regulations provide that centralized management exists in a limited partnership if "substantially all" the interests in the partnership are owned by the limited partners.<sup>117</sup> The IRS further clarified these regulations in Revenue Proceeding 89-12,<sup>118</sup> where it stated that a limited partnership will generally lack centralized management if the general partners own at least twenty percent of the total interests in the partnership.<sup>119</sup> Theoretically, this ruling suggests that if the designated managers of an LLC own at least a twenty percent interest in the organization, then centralized management will be lacking.<sup>120</sup> However, the IRS has not expressly ruled that Revenue Proceeding 89-12 is applicable to LLCs.<sup>121</sup> Moreover, Revenue Ruling 88-76 does not shed much light on this issue because in its decision, the IRS did not state the percentage of the LLC owned by the designated managers.<sup>122</sup> Furthermore, there are some significant differences, such as in the area of personal liability, that exist between general partners and LLC managers that could lead the IRS to conclude that Revenue Proceeding 89-12 is inapplicable to LLCs.<sup>123</sup>

The IRS added another layer of complexity to the application of the continuity of life characteristic with Revenue Ruling 93-6, in which it addressed the classification of an LLC to be formed under

<sup>115</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360.

<sup>116</sup> See Ray, *supra* note 96, at 858. "It is arguable that an LLC that vests its managerial authority in designated managers may still lack centralized management under certain circumstances." *Id.*

<sup>117</sup> See Treas. Reg. § 301.7701-2(c)(4) (as amended in 1993).

<sup>118</sup> Rev. Proc. 89-12, 1989-2 C.B. 798.

<sup>119</sup> *Id.*; see also Ray, *supra* note 96, at 859. "Apparently, the rationale supporting both the treasury regulations and Revenue Procedure 89-12 is that, if the general partners do not own a substantial interest, they must be managing the business for the true owners, the limited partners." *Id.*

<sup>120</sup> See Rev. Proc. 89-12, 1989-1 C.B. 798 § 1.02. "Any reference to a 'limited partnership' includes an organization formed as a limited partnership under applicable state law and any other organization formed under a law that the liability of any member for the organization's debts and other obligations to a determinable fixed amount." *Id.* The IRS noted that managers will be treated as general partners and nonmanagers will be treated as limited partners. *Id.*

<sup>121</sup> See Ray, *supra* note 96, at 859.

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*; see also Keatinge et al., *supra* note 2, at 429.

the Colorado Limited Liability Company Act.<sup>124</sup> The LLC in question was composed of five members, each of whom was elected as a manager.<sup>125</sup> The IRS reasoned that the authority to make management decisions rested solely with the five members in their capacity as managers rather than as members, and therefore concluded that the LLC possessed the characteristic of centralized management.<sup>126</sup>

This ruling is important because it suggests that the IRS will never analyze the proprietary ownership of an LLC to determine what percentage of owners are managers, if, under the statute, the managers are acting in their capacity as managers.<sup>127</sup> Even though all five members were designated as managers and had a meaningful proprietary interest in the LLC, the IRS concluded that the LLC possessed centralized management.<sup>128</sup> Consequently, it appears that any LLC that designates management solely by elected managers will possess centralized management, even if all of the members of the LLC are elected as managers.<sup>129</sup>

#### D. Free Transferability of Interests

The final determinative corporate characteristic is free transferability of interests. Under the Treasury Regulations, an organization possesses this characteristic if its members or those members owning "substantially all" of the interests in the organization have the power, without the consent of the other members, to substi-

<sup>124</sup> See Rev. Rul. 93-6, 1993-3 I.R.B. 8.

<sup>125</sup> *Id.*

<sup>126</sup> See Rev. Rul. 93-6, 1993-3 I.R.B. 8. Revenue Ruling 93-6 provides in pertinent part: Under the [Colorado Limited Liability Company Act], the management of a limited liability company is vested in managers elected by the company's members. The elected managers may or may not be members of the company, and may or may not include all members of the company. Members, by sole virtue of being members, do not possess managerial authority. Although all of M's members are elected managers of M, M nevertheless possesses centralized management, because as provided by the Act, authority to make management decisions rests solely with the five members in their capacity as managers rather than as members.

*Id.*

<sup>127</sup> See Harmon, *supra* note 83.

<sup>128</sup> See Rev. Rul. 93-6, 1993-3 I.R.B. 8.

<sup>129</sup> See *id.* (noting that although all LLC's members were elected as managers, LLC still possessed centralized management); see also Anderson, *supra* note 97, at 80-81 (recognizing that Revenue Ruling 93-6 is particularly noteworthy because it indicates that if LLC designates management solely by elected managers, it will possess centralized management, even if elected managers are all members); Matthews, *supra* note 12, at 865 (noting that it appears that election of managers will result automatically in finding that LLC possesses centralized management); Harmon, *supra* note 83 (noting that IRS is actively considering this issue).

tute for themselves in the organization a person who is not a member of the organization.<sup>130</sup> The regulations define the power of substitution as the ability of a member, without the consent of other members, to confer upon his/her substitute all of the attributes of the member's interest in the organization.<sup>131</sup> This includes not only the right to share in the profits of the business, but also the right to participate in the management of the organization.<sup>132</sup>

Revenue Ruling 88-76 provides both insight and guidance as to how the free transferability of interest characteristic applies to LLCs.<sup>133</sup> In that ruling, the IRS reasoned that a Wyoming LLC lacked the characteristic of free transferability of interests because, under the Wyoming statute, an assignee of a member's interest could not become a substitute member and acquire all the attributes of the member's interest unless all of the remaining members consented to the assignment.<sup>134</sup> The IRS concluded that the ability of a member to assign only the right to share in the profits and not the right to participate in the management of the organization was not sufficient to conclude that the LLC possessed free transferability of interests.<sup>135</sup> Thus, an LLC will lack free transferability if its members, or those members owning a substantial interest in the LLC, may not transfer their full membership rights without the unanimous consent of the other members.

It is less clear, however, whether an LLC will be held to lack this corporate characteristic if transferability is conditioned upon a standard short of unanimous consent of the remaining members.<sup>136</sup> For instance, the LLC might condition transfer of a member's full membership rights on the approval of a majority in inter-

<sup>130</sup> See Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993).

<sup>131</sup> *Id.*

<sup>132</sup> See *id.* The characteristic of free transferability of interests does not exist where each member can, without the consent of other members, only assign the right to share in profits but cannot so assign the right to participate in the management of the organization. *Id.* Absent consensual restrictions, a stockholder's rights and interest in a corporation are freely transferable without reference to the desires of other members. See *Larson v. Commissioner*, 66 T.C. 159, 182 (1976). A partner, on the other hand, can unilaterally transfer only his right to share in the partnership "profits and surplus," and cannot confer on the transferee the other attributes of membership without the consent of all the other partners. *Id.*; see also UNIF. PARTNERSHIP ACT § 18(g). Section 18(g) provides: "No person can become a member of a partnership without the consent of all the other partners." *Id.*

<sup>133</sup> See Ray, *supra* note 96, at 857.

<sup>134</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360.

<sup>135</sup> *Id.*

<sup>136</sup> See Matthews, *supra* note 12, at 869; see also Ray, *supra* note 96, at 858 (noting if LLC's regulations allow for anything less than unanimous consent, LLC could risk possessing free transferability of interests).

est of the nontransferring members or consent of the manager.<sup>137</sup> The IRS has addressed these types of transfer schemes in several private letter rulings.

In Private Letter Ruling 92-10-019,<sup>138</sup> the IRS addressed an LLC organized under the Texas Limited Liability Act,<sup>139</sup> which allows LLCs to establish their own regulations regarding transferability.<sup>140</sup> The regulations of the LLC at issue provided that the LLC's members could not transfer their full ownership interest without first obtaining either the consent of the manager or, if the manager was not a member or was the member making the transfer, consent of a majority in interest of the other members.<sup>141</sup> The IRS concluded that the LLC lacked the characteristic of free transferability of interests.<sup>142</sup> Two months later, in Private Letter Ruling 92-19-022,<sup>143</sup> the IRS addressed a Utah LLC whose operating agreement required the consent of a majority of the nontransferring members prior to a member's transfer of full membership rights.<sup>144</sup> Again, the IRS ruled that the LLC did not possess free transferability.<sup>145</sup>

Based on these private letter rulings, the IRS appears to have taken the position that an LLC will lack free transferability if prior to the transfer of a member's full ownership interest, the member must obtain the consent of either the sole manager, provided that the manager is also a member of the LLC, or at least a majority in interest of the nontransferring members.<sup>146</sup> However, because private letter rulings only apply to the taxpayer who ob-

<sup>137</sup> See Ray, *supra* note 96, at 858.

<sup>138</sup> Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991).

<sup>139</sup> TEX. REV. CIV. STAT. ANN. art. 1528n, arts. 1.01 to 9.02 (West Supp. 1994).

<sup>140</sup> See *id.* art. 4.05A; see also Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991); Anderson, *supra* note 97, at 75.

<sup>141</sup> See Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991). The LLC's regulations also provided that the interest of any member in the LLC could be transferred without the consent of the manager or members if the transfer occurred by reason of death, dissolution, divorce, or termination of the member, and transfer was to a "permitted transferee." *Id.*; see also Anderson, *supra* note 97, at 75.

<sup>142</sup> See Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991); see also Priv. Ltr. Rul. 92-18-078 (Jan 31, 1992) (another Texas LLC held to lack free transferability although substitution of member conditioned on consent of manager or members owning at least two-thirds of ownership interests).

<sup>143</sup> Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992).

<sup>144</sup> *Id.*; see also UTAH CODE ANN. §§ 48-2b-131 (1994); Anderson, *supra* note 97, at 76.

<sup>145</sup> See Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992).

<sup>146</sup> See Anderson, *supra* note 97, at 76.

tains the ruling, business planners should still exercise caution when drafting provisions to govern transferability of interests.<sup>147</sup>

### III. OTHER CONSIDERATIONS

#### A. Moral Hazard

Under the doctrine of limited liability, if a judgment is rendered against an organization in an amount that exceeds its ability to pay, judgment creditors cannot pursue the organization's individual members to collect the residual amount.<sup>148</sup> The doctrine originated from the idea that limiting liability would promote investment by small entrepreneurs, keep the business market competitive, and create more revenue for the small-scale business.<sup>149</sup> However, whenever limited liability exists in an organization, there is also the possibility of a moral hazard problem. More specifically, the moral hazard present in business forms like the LLC is the "incentive created by limited liability to transfer the cost of risky activities to creditors."<sup>150</sup>

Nevertheless, the limited liability doctrine, historically, offers several significant advantages.<sup>151</sup> First, the need for investors to closely observe their investments diminishes with limited liability

<sup>147</sup> *Id.* (noting that planners must exercise caution when drafting provisions to govern transferability of ownership interests); see also Robert G. Lang, *Utah's Limited Liability Company Act: Viable Alternative or Trap for the Unwary?*, 1993 UTAH L. REV. 941, 964 (noting that because private rulings carry no precedential value, planners should not solely rely on them).

<sup>148</sup> See Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 387-88 (1992).

<sup>149</sup> See Stephen Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148, 155 (1992). The author notes:

The popular democratic justification for limited liability is rarely observed by modern scholars. Nevertheless, it appears that to the nineteenth-century legislators in states such as New York, who mandated limited liability for corporations' shareholders, the imposition of limited liability was perceived as a means of encouraging the small-scale entrepreneur, and of keeping entry into business markets competitive and democratic. . . . Without the contributions of investors of moderate means, it was felt, the kind of economic progress states like New York needed would not be achieved.

*Id.*

<sup>150</sup> See Frank Easterbrook & Daniel Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 104 (1985) (noting that limited liability increases probability of insufficient assets to pay creditors); see also Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 140 (1980) (noting possibility of "moral hazard problem" when limited liability exists); Grundfest, *supra* note 148, at 388 (noting that critics claim limited liability provides incentive for excessive risk-taking and unfairly limits recoveries by plaintiffs with valid claims against organization).

<sup>151</sup> See David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1566 (1991) (describing limited liability as well established in capitalist law and essential to modern corporate structure).

because investors will have a diversified portfolio of investments with only a small percentage of money invested in any one firm.<sup>152</sup> On the other hand, investors subject to unlimited liability would scrutinize their investments and other shareholders' activities much more closely, thereby increasing monitoring and operating costs.<sup>153</sup>

A second advantage to limited liability is that it facilitates diversification.<sup>154</sup> Under a rule of limited liability, investors can effectively hedge and minimize risk by owning a diversified portfolio of assets.<sup>155</sup> In contrast, with a rule of unlimited liability, any one shareholder's investment could result in a loss of his or her entire wealth.<sup>156</sup> Consequently, diversification would be discouraged in order to limit the potential exposure to liability, and the cost to firms of raising capital would rise.<sup>157</sup>

Finally, limited liability allows for maximization of investments.<sup>158</sup> When limited liability exists, managers can invest in any project without exposing investors to personal bankruptcy.<sup>159</sup> This includes investing in riskier ventures, such as the development of new and unique products.<sup>160</sup> Since it is not economically practical for investors to hold diversified portfolios in a world of unlimited liability, managers in such a world would reduce risk

<sup>152</sup> See Presser, *supra* note 149, at 158. The author notes that with the presence of unlimited liability, "shareholders would find it necessary to monitor closely the activities of their corporations in order to escape liability, and that the high cost of this monitoring would itself discourage investment." *Id.*

<sup>153</sup> See Presser, *supra* note 149, at 158 (noting that unlimited shareholder liability increases monitoring costs). Since the monitoring costs of an organization would decrease with limited liability, the operating costs would also decrease. *Id.*

<sup>154</sup> See Easterbrook & Fischel, *supra* note 150, at 96-97 (noting that productive diversification can be achieved with limited liability).

<sup>155</sup> *Id.*

<sup>156</sup> See Presser, *supra* note 149, at 161. The author notes that one of the arguments against a rule of unlimited liability is that under such a regime, "any one shareholder's investment could result in wiping out his or her wealth, [thus] diversification would be discouraged, rather than encouraged, in order to limit the risk of catastrophic liability." *Id.*

<sup>157</sup> See Easterbrook & Fischel, *supra* note 150, at 96-97 (noting that diversified portfolio of assets decreases risk investor faces and therefore, companies can raise capital at lower cost); see also G. Michael Epperson & Joan M. Canny, *The Capital Shareholder's Ultimate Calamity: Pierced Corporate Veils and Shareholder Liability in the District of Columbia, Maryland, and Virginia*, 37 CAT. U. L. REV. 605, 606 (1988) (noting that limited liability facilitates accumulation of enterprise capital).

<sup>158</sup> See Easterbrook & Fischel, *supra* note 150, at 97 (noting that "limited liability facilitates optimal investment decisions").

<sup>159</sup> See Easterbrook & Fischel, *supra* note 150, at 97. When investors hold diversified portfolios, managers maximize investors' welfare by investing in any project with a positive net present value. *Id.*

<sup>160</sup> *Id.*



for investors by rejecting certain speculative projects with a positive net present value.<sup>161</sup> This would result in a loss to the economy and society as a whole, because by definition, projects with a positive net present value are beneficial uses of capital.<sup>162</sup>

In sum, the various economic and financial advantages associated with the concept of limited liability outweigh any risk associated with the moral hazard problem.<sup>163</sup> The limited liability concept, and consequently the LLC, allows for more efficient diversification, facilitates optimal investment decisions, decreases the need to monitor the firm and other shareholders, and increases the availability of capital to the firm. Moreover, the moral hazard problem can be effectively controlled by various safety valves such as written contracts including specific provisions constraining the actions of the firm, personal guarantees from the owners of the firm, and by piercing the LLC veil.<sup>164</sup>

### B. Piercing the Limited Liability Company Veil

One of the most important features of the LLC is that, like shareholders of a corporation, its members are not liable for the debts and obligations of the organization beyond the amount of

<sup>161</sup> See Easterbrook & Fischel, *supra* note 150, at 97 (noting that under rule of unlimited liability, managers would reject as "too risky" some projects with positive net present value); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1039 (1991). The author notes: "The possibility that the failure of a business would allow its creditors to reach all of an investor's nonbusiness assets might deter a risk averse investor from investing, even though the risk is small and the investment has a positive net present value. Limited liability encourages these investments." *Id.*; see also BLACK'S LAW DICTIONARY 1041 (6th ed. 1990). Net present value ("NPV") is defined as "[t]he present value of the stream of net cash flows resulting from a project, discounted at the firm's cost of capital, minus the project's net investment. It is used to evaluate, rank, and select among various investment projects." *Id.*

<sup>162</sup> See Easterbrook & Fischel, *supra* note 150, at 97 (noting that increased availability of funds for projects with positive net present values is real benefit of limited liability).

<sup>163</sup> See Grundfest, *supra* note 148, at 421. The author notes that "[f]or all the academic controversy, the evidence is hardly overwhelming that limited liability causes a significant increase in an [organization's] willingness to engage in risky behavior." *Id.*

<sup>164</sup> See Epperson & Canny, *supra* note 157, at 643. The authors note: "[B]usiness activity . . . thrives, and encourages investment from a variety of sources, where the associated risk is carefully controlled. Limited liability serves such a purpose for the American [business] enterprise. Well counseled investors will understand that . . . it is incumbent upon them to safeguard their limited liability by maintaining the fiction, and thereby the integrity of the [business] form. The doctrine of piercing the corporate veil serves as . . . [an] exception to limited liability in particularly egregious circumstances.

*Id.*; see also Sandra K. Miller, *What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?*, 68 ST. JOHN'S L. REV. 21, 78-79 (1994). The author suggests that a standard of due care or ordinary negligence is more appropriate than a gross negligence standard for members and managers of LLCs. *Id.*

their investment.<sup>165</sup> However, since the LLC is a relatively new business form, caselaw has yet to address the scope of a member's limitation on liability.<sup>166</sup> Thus, the question remains as to what extent the doctrine of piercing the corporate veil will apply to LLCs.<sup>167</sup> To attempt to answer this question, one must look to the corporate form to determine when and why personal liability is sometimes imposed on a corporation's shareholders.<sup>168</sup>

A shareholder of a corporation, in certain circumstances, can be held personally liable for the debts and obligations of the organization.<sup>169</sup> The principal way of imposing such liability on shareholders is through the judicial doctrine of piercing the corporate veil.<sup>170</sup> As stated in *Carte Blanche Ltd. v. Diners Club International, Inc.*,<sup>171</sup> the general rule is that personal liability will not be imposed on the shareholders unless they abuse their right to limited liability by using the corporation for dishonest or improper purposes.<sup>172</sup> Although courts do not apply definitive legal standards when analyzing piercing issues, they have traditionally fo-

<sup>165</sup> See Keatinge et al., *supra* note 2, at 412 (noting that members of LLC cannot be held personally liable for LLC's debts); see also Easterbrook & Fischel, *supra* note 150, at 89-90.

<sup>166</sup> See Keatinge et al., *supra* note 2, at 442. The authors note: "Because of the relatively recent development of the LLC in the United States, there are no reported cases involving the liability of LLC members." *Id.* But see *Abu-Nassar v. Elders Futures, Inc.*, No. 88 Civ. 7906, 1991 U.S. Dist. LEXIS 3794 (S.D.N.Y. Mar. 28, 1991) (concerning liability of members of a Lebanese LLC).

<sup>167</sup> See Curtis J. Braukmann, Comment, *Limited Liability Companies*, 39 KAN. L. REV. 967, 991 (1991) (noting that courts have yet to define degree to which piercing will apply to LLCs); Gazur & Goff, *supra* note 31, at 401 (noting that issues exist as to whether veil piercing applies to LLCs); see also Hamill, *supra* note 28, at 751 (noting difficulty in predicting when courts will pierce corporate veil).

<sup>168</sup> See Fonfara & McCool, *supra* note 11, at 531. Corporate shareholders and LLC members are both statutorily protected from personal liability. *Id.*

<sup>169</sup> See REV. MODEL BUSINESS CORP. ACT § 6.22 (1984). The Act provides in relevant part: "Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct."

*Id.*

<sup>170</sup> See Thompson, *supra* note 161, at 1036. "Piercing the corporate veil refers to the [judicial doctrine] by which courts disregard the separateness of the corporation and hold a shareholder responsible for the corporation's actions as if it were the shareholder's own." *Id.*

<sup>171</sup> 2 F.3d 24, 26 (2d Cir. 1993); see *Wm. Passalacqua Builders, Inc. v. Resnick Developers South, Inc.*, 933 F.2d 131 (2d Cir. 1991).

<sup>172</sup> *Carte Blanche Ltd.*, at 2 F.3d at 26; see *Walkovsky v. Carlton*, 18 N.Y.2d 414, 417, 223 N.E.2d 6, 7, 276 N.Y.S.2d 585, 587 (1966). "[C]ourts will disregard the corporate form, or to use more accepted terminology, pierce the corporate veil, whenever necessary to prevent fraud or to achieve equity." *Id.*; Hamill, *supra* note 28, at 744. The concept of piercing the corporate veil is based on common law, rather than state or federal statutory law. *Id.* This concept is one of the most frequently litigated theories in corporate law. See Thompson, *supra* note 161, at 1036.

cused on several common factors in deciding whether to pierce the corporate veil.<sup>173</sup> These factors include whether the case involved an involuntary creditor,<sup>174</sup> whether the shareholders were engaged in fraud or misrepresentation,<sup>175</sup> whether the corporation was inadequately capitalized,<sup>176</sup> and whether corporate formalities were followed.<sup>177</sup>

Not all factors considered in corporate piercing cases equally apply to the LLC.<sup>178</sup> Because the flexibility of the LLC's management structure allows it to operate without observing the type of

<sup>173</sup> See *United States v. Healthwin-Midtown Convalescent Hosp. & Rehabilitation Ctr.*, 511 F. Supp. 416, 418-19 (C.D. Cal. 1981), *aff'd mem.*, 685 F.2d 448 (9th Cir. 1982) (noting that courts consider several factors in piercing corporate veil such as adequacy of corporation's capitalization, commingling corporate and noncorporate assets, and failure to observe corporate formalities). Whether to pierce the corporate veil depends upon the factors present in each case. *Id.* at 418. Courts may decide to pierce the corporate veil when fraud is discovered or to produce an equitable result. See *International Aircraft Trading Co., Inc. v. Manufacturers Trust Co.*, 297 N.Y. 285, 292, 79 N.E.2d 249, 252, 71 N.Y.S.2d 923, 923 (1948) (noting that piercing corporate veil occurs to prevent fraud or to achieve equity); see also *Pardo v. Wilson Line of Washington, Inc.*, 414 F.2d 1145, 1149-50 (D.C. Cir. 1969) (noting that courts do not normally pierce corporate veil because corporation presumed to be properly formed and operated).

<sup>174</sup> See *Braukmann*, *supra* note 167, at 991. Courts are substantially more likely to pierce the corporate veil on behalf of a tort or other involuntary creditor than on behalf of one who has voluntarily elected to look solely to the corporation's credit. *Id.* Even a contract claimant may be an involuntary creditor since some parties to a contract possess little bargaining power. *Id.* at 991 n.160. *But see* *Thompson*, *supra* note 161, at 1036 (noting that more veil piercing occurs in contract cases than in tort cases).

<sup>175</sup> See *Larry R. Ribstein, Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 111 (1991) (noting that material misrepresentation or nondisclosure may be appropriate grounds for piercing corporate veil); see also *Keatinge et al.*, *supra* note 2, at 444 (noting that factors for veil piercing include "lack of separateness, inadequate capitalization, illegal purpose, equity and justice, and failure to comply with corporate formalities."); *Thompson*, *supra* note 161, at 1063-70.

<sup>176</sup> See *Braukmann*, *supra* note 167, at 991. Most courts view undercapitalization as one of the most significant factors in deciding whether to pierce the corporate veil. *Id.*; see also *Thompson*, *supra* note 161, at 1065 (noting that commentators cite undercapitalization as part of normative standard in piercing cases). However, the vast majority of courts hold that although grossly inadequate capitalization is an important factor, it is not dispositive. See *Walkovsky*, 18 N.Y.2d at 419, 223 N.E.2d at 9, 276 N.Y.S.2d at 589. The corporate form may not be disregarded merely because the assets of the corporation are insufficient to assure the recovery sought. *Id.* The majority of courts require either fraud by the shareholder or a failure to follow corporate formalities before the veil will be pierced. *Id.* at 419, 223 N.E.2d at 10, 276 N.Y.S.2d at 590; see also *Harris v. Curtis*, 8 Cal. App. 3d 837, 841 (Ct. App. 1970) (noting undercapitalization as only one factor to consider in veil piercing). *But see* *Minton v. Cavaney*, 364 P.2d 473, 475 (Cal. 1961) (appearing to hold that involuntary creditor may pierce corporate veil if there has been grossly inadequate capitalization, even in absence of fraud or failure to follow corporate formalities).

<sup>177</sup> See *Thompson*, *supra* note 161, at 1067. The author states: "[c]ommentators note that courts nearly always cite disregard of formalities, and that failure to maintain formalities substantially increases the probability of piercing." *Id.* Some examples of failure to follow corporate formalities are where the corporation never formally issues shares, never holds shareholders' and directors' meetings, and fails to distinguish between corporate property and personal property. See *Fonfara & McCool*, *supra* note 11, at 531-32.

<sup>178</sup> See *Braukmann*, *supra* note 167, at 992.

formalities imposed on corporations, an LLC's failure to comply with corporate-like formalities is less likely to create a veil piercing problem.<sup>179</sup> However, despite this difference, courts are likely to treat the LLC similar to the corporation with respect to piercing. Like a corporation's shareholders, members of an LLC are entitled to participate in firm management without losing the protection of limited liability.<sup>180</sup> For this reason alone, corporate caselaw may be appropriately analogous for LLC veil piercing purposes.<sup>181</sup> Furthermore, states may statutorily mandate that courts apply corporate caselaw to LLCs in this area.<sup>182</sup> Colorado, for example, has a statute which requires that the conditions and circumstances under which a corporation's veil may be pierced under Colorado law be considered when a party seeks to hold members of an LLC personally liable.<sup>183</sup>

### C. Choice of Law

The use of LLCs outside the state in which they are formed remains a consideration when choosing it as a business form.<sup>184</sup> Despite the fact that LLCs are now recognized in thirty six states, the question remains as to whether the limited liability status of members will be recognized by states that have no LLC legislation.<sup>185</sup> An LLC doing business or operating in a state with no

<sup>179</sup> See Keatinge et al., *supra* note 2, at 446 (noting that in LLC context, it is questionable whether failure to follow corporate-like formalities should even be factor in LLC piercing analysis). In contrast to the LLC, traditional business entities are usually required to conform to certain operational guidelines that limit their flexibility. See Lang, *supra* note 147, at 961. For example, corporations generally must treat all stockholders within a class of stock equally with respect to dividend payments and voting rights. *Id.*; see also N.Y. BUS. CORP. LAW § 501(c) (McKinney 1986 & Supp. 1994). Corporations are also required to hold annual stockholder meetings. *Id.*; see also N.Y. BUS. CORP. LAW § 602(b) (McKinney 1986 & Supp. 1994).

<sup>180</sup> See Keatinge et al., *supra* note 2, at 445 (noting that LLC members, like corporate shareholders and contrary to limited partners under RULPA, are entitled to participate in management without losing limited liability protection).

<sup>181</sup> *Id.*

<sup>182</sup> See Braukmann, *supra* note 167, at 992 (noting that states can statutorily mandate caselaw pertaining to piercing corporate veil will apply to LLCs).

<sup>183</sup> COLO. REV. STAT. ANN. § 7-80-107 (West Supp. 1993). The Colorado Act provides: In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.

*Id.*

<sup>184</sup> See Brian L. Schorr, *Limited Liability Companies: Considerations in Choosing a Business Entity*, 1994, available in WESTLAW, Texts and Periodicals Database, PLI File.

<sup>185</sup> *Id.*

LLC legislation encounters the risk of exposing its members to personal liability for the LLC's debts, contracts, and tortious actions.<sup>186</sup> Traditional notions of choice of law and comity must be examined in order to determine the extent and likelihood of this exposure.<sup>187</sup>

Choice of law principles dictate which state's laws should apply to a particular cause of action. In the case of an LLC, a court might be faced with a situation where the laws of one state do not recognize the limited liability status of an LLC's members. In that situation, the court will either apply the Full Faith and Credit Clause, the Interstate Commerce Clause, or another state's laws based upon the public policy of the forum state.

The first choice of law principle to consider is the Full Faith and Credit Clause, which provides that each state shall recognize "the public Acts, Records, and judicial Proceedings of every other State."<sup>188</sup> In order to ensure that choice of law is neither arbitrary nor fundamentally unfair, the application of a forum state's law to a controversy will be sustained under the Full Faith and Credit Clause only if sufficient state contacts exist with the forum state.<sup>189</sup> The challenge to the limited liability status of a foreign LLC entering another state will usually be triggered by the LLC's business activities, ownership of property, or tortious conduct in the forum state.<sup>190</sup> Typically, such contacts with the forum state will establish a sufficient state interest to enable the forum state to constitutionally look to its statutes in deciding whether to recognize a foreign LLC, in particular, the limited liability status of its members.<sup>191</sup>

The Interstate Commerce Clause, a second choice of law principle, may also influence whether the limited liability provisions of an LLC's state of organization will be adopted in a forum state

<sup>186</sup> *Id.*

<sup>187</sup> *Id.*; see also Braukmann, *supra* note 167, at 987 (noting that whether sister state will respect limited liability and other state law characteristics of LLC in tort and contract actions is question of judicial comity).

<sup>188</sup> U.S. CONST. art. IV, § 1; see also COLO. REV. STAT. ANN. § 7-80-106 (West Supp. 1993). Colorado's statute requests that LLCs transacting business outside of Colorado "be granted the protection of full faith and credit under section 1 of Article IV of the Constitution of the United States." *Id.*

<sup>189</sup> See *Allstate v. Hague*, 449 U.S. 302, 310-11 (1981) (holding that state interest was created because Minnesota had significant contacts with parties and occurrence).

<sup>190</sup> See Gazur & Goff, *supra* note 31, at 435.

<sup>191</sup> See *id.* at 435-36 (noting that forum states would not be precluded from looking to their own statutes if significant contacts exist).

without an LLC statute.<sup>192</sup> Specifically, the Interstate Commerce Clause may require a forum state to recognize the law of the LLC's state of organization over its own law in order to prevent the risk of inconsistent regulation that would impede interstate commerce.<sup>193</sup> Because the laws relating to business organizations differ from state to state, the application of the law of every state in which an LLC transacts business could result in an impermissible risk of inconsistent regulation.<sup>194</sup> However, by recognizing the law of the LLC's state of organization pursuant to the Interstate Commerce Clause, the risk of inconsistent regulation would be virtually eliminated and the ability of the LLC to take advantage of interstate capital markets would be greatly increased.<sup>195</sup>

Finally, the common law doctrine of comity may also play an important role in determining how LLCs will be treated by states without LLC legislation.<sup>196</sup> Comity is the principle that the courts of one state or jurisdiction will give effect to the laws and judicial decisions of another state, not as a matter of obligation, but out of deference and goodwill.<sup>197</sup> However, courts will disregard the doctrine of comity if the law of the foreign state is inconsistent with the public policy of the forum state.<sup>198</sup> That is, a state need not

<sup>192</sup> U.S. CONST. art. I, § 8, cl. 3. The Interstate Commerce Clause "regulate[s] Commerce with foreign Nations, and among the several States, and with the Indian Tribes." *Id.*

<sup>193</sup> See *Dennis v. Higgins*, 498 U.S. 439, 446 (noting that Interstate Commerce Clause limits power of state to erect barriers against interstate trade); see also *Keatinge et al.*, *supra* note 2, at 455 (stating that Interstate Commerce Clause may bar forum state from applying its own laws as opposed to foreign state law).

<sup>194</sup> See *Keatinge et al.*, *supra* note 2, at 456 (noting that applying law of every state LLC transacts business in could create inconsistent regulation).

<sup>195</sup> See *id.* at 456 (noting that recognition of LLC's state of organization favors LLC in interstate market).

<sup>196</sup> See *supra* notes 186-87 and accompanying text.

<sup>197</sup> BLACK'S LAW DICTIONARY 267 (6th ed. 1990).

<sup>198</sup> See 17 WILLIAM M. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8331 (rev. perm. ed. 1987) (noting that comity is principle that forum state will enforce rights granted by foreign state unless enforcement is "inconsistent with any statute or public policy of the [forum] state . . ."); *Johnson*, *supra* note 27, at 401 (noting that courts will recognize presumption of comity unless state has affirmative public policy which directly opposes law of other state). If the law of the foreign state differs from the public policy of the forum state, especially where enforcement of such activities would be injurious to the welfare of the forum state's citizens, then the forum state is not bound to follow the law. See *Wehrhane v. Peyton*, 58 A.2d 698, 700 (Conn. 1948). Absent caselaw regarding comity and the limited liability company, one rationally looks at comity as it applies to other business forms. See *Rodriguez*, *supra* note 2, at 553. The author notes: "[i]n absence of case law concerning the application of the doctrine of comity to a LLC, it may be helpful to look at the application of the public policy exception to the doctrine of comity by way of analogy to a similar business form." *Id.* This view suggests two possible approaches that might be applied by a court in a non-LLC state. See *Braukman*, *supra* note 167, at 987. The first approach is to treat the LLC based upon the laws of the state where formation oc-

recognize another state's laws when the application of such laws would violate its own laws or impede its own policies. Therefore, business planners considering the use of an LLC must carefully review the statutes and caselaw of the states where the LLC intends to do business. Only by doing so can they determine if respect for the limited liability characteristic of the LLC impedes the public policy of those states.

In short, no specific standard exists to determine whether states without LLC legislation will recognize and respect the limited liability status of a foreign LLC's members. Nevertheless, choice of law principles indicate that the forum state should adopt the provisions of the LLC's state of organization unless sufficient contacts exist with the forum state or its policies are violated.<sup>199</sup> Additionally, states can help facilitate uniform respect for the LLC by including provisions in their respective statutes requesting recognition by other states and offering the same recognition to foreign LLCs operating within their boundaries.<sup>200</sup> For example, Colorado specifically addresses out-of-state recognition by specifying the rights and responsibilities of a foreign LLC seeking to do business within its state.<sup>201</sup> The Colorado Act provides that, subject to the Colorado constitution, the "laws of the jurisdiction under which a foreign limited liability company is organized govern its organization and internal affairs and the liability of its members . . . ."<sup>202</sup> Further, the Colorado Act contains a provision indicating that it is the intention of the Colorado General Assembly that an LLC formed under the Colorado Act, which transacts business outside the state, be granted the protection of the Full Faith and Credit

curred, which is called "complete comity." *Id.* at 987-88; see also *Downey v. Swan*, 90 A.D.2d 493, 493, 454 N.Y.S.2d 895, 896 (2d Dep't 1982) (applying this approach to New Jersey partnership association). The second approach is for a court to classify a foreign LLC as a corporation or a partnership based upon the forum state's laws. See Braukmann, *supra* note 167, at 988. This approach is referred to as "partial comity." *Id.*

<sup>199</sup> See *supra* notes 184-98 and accompanying text (discussing factors to consider in determining whether provisions from LLC's organized state apply in forum state); see also Keatinge et al., *supra* note 2, at 456 (noting that choice of law indicates foreign courts should treat LLC as foreign corporation and apply laws of LLC's state of organization); Braukman, *supra* note 167, at 990 (noting that LLC must look to policies of foreign state before performing business in that state).

<sup>200</sup> See Braukmann, *supra* note 167, at 989-90 (noting that states can build wider respect for LLC into statutory provisions which ask for recognition by other states or offer it to LLCs formed in other states).

<sup>201</sup> See COLO. REV. STAT. § 7-80-901 to -913 (Supp. 1993).

<sup>202</sup> COLO. REV. STAT. § 7-80-901 (Supp. 1993); see also Braukmann, *supra* note 167, at 990.

Clause under section 1 of article IV of the United States Constitution.<sup>203</sup> Although such a provision does not ensure that courts of other states will recognize the limited liability status of an LLC's members, it at least makes clear the precise intention of the state legislature.<sup>204</sup> From a practical viewpoint, however, until the uncertainty diminishes, the decision to use an LLC in a state that does not statutorily recognize LLCs should be approached cautiously on a case-by-case basis. Business planners should carefully weigh the risks inherent in the particular business, the client's need for limited liability, the amount of contacts with the foreign state, and the public policies of the foreign state.

### CONCLUSION

Although a relatively recent development, the LLC presents an exciting new alternative to the corporate or partnership form of doing business. In addition to limited liability and partnership tax treatment, the LLC offers the business planner a significant amount of flexibility in structuring governance and financial arrangements. However, despite its appealing characteristics, the LLC still faces certain obstacles. In particular, if members are not cautious when structuring the LLC, the IRS may tax the organization as a corporation rather than as a partnership. To achieve partnership tax treatment, business planners must structure the LLC to lack two of the four characteristics indigenous to corporations: (1) limited liability; (2) centralization of management; (3) continuity of life; and (4) free transferability of interests. If this is not accomplished, the entity will be classified as a corporation for federal income tax purposes. Further, certain unresolved issues such as recognition of the LLC in states without LLC legislation and the extent to which the doctrine of piercing the veil will apply raise important questions as to when members can become personally liable. Most of these uncertainties, however, have arisen because of the LLC's limited use up to this time and the lack of caselaw to guide business planners. Thus, as additional states adopt LLC statutes and the courts address some of the fundamental legal issues, many of these obstacles will be overcome and the

<sup>203</sup> See COLO. REV. STAT. § 7-80-106 (Supp. 1993).

<sup>204</sup> See Braukmann, *supra* note 167, at 991 (noting that such provision makes intention of Colorado legislature clear and so should facilitate judicial comity).



**LLC will emerge as the optimal solution to one of the most vexing structural dilemmas in business: maximizing favorable tax treatment while minimizing personal liability.**

*Scott Kapusta & Brian Nichols*