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THE DOCTRINE OF PIERCING THE VEIL IN AN ERA OF MULTIPLE LIMITED LIABILITY ENTITIES: AN OPPORTUNITY TO CODIFY THE TEST FOR WAIVING OWNERS' LIMITED-LIABILITY PROTECTION

John H. Matheson* & Raymond B. Eby†

Abstract: The use of the corporate form of business organization has always provided a firm's owners/shareholders with a presumptive shield from personal liability for the debts of the business. Case-by-case exceptions to this limited-liability shield have developed in each state under the general rubric of "piercing the veil." Courts and commentators alike have noted the vagueness of the piercing analysis and have questioned the appropriateness of some of the factors employed in that analysis. In addition, new forms of business entities, such as limited liability companies and limited liability partnerships, have been legislatively created over the past several decades, raising the issue of whether and by what standards their limited-liability shields will be pierced. This is an opportune time to reexamine the piercing doctrine and to provide a uniform standard for all forms of limited liability entities. The authors propose a Model Statute to replace the current common-law doctrine for determining when piercing will take place. Under the Model Statute, piercing is limited to situations in which the business owner (1) misrepresents the assets of the business, (2) engages in self-dealing transactions, or (3) takes assets from the business under circumstances that render the business insolvent. In the latter two situations, the owner's liability is limited to the amount received by the owner in excess of the value given in return unless the owner knew or should have foreseen that the transfer would result in the insolvency of the business.

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"The whole problem of the relation between [owners and their] corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it."[1]

"Do you notice anything intellectually disturbing about this [standard piercing-the-corporate-veil] formulation? That's right; IT'S vague. It hardly gives you any concrete idea about which conduct does or does not trigger the doctrine—not enough of an idea, at least, to give you the ability to counsel clients in a meaningful way."[2]

I. INTRODUCTION

Use of the corporate form for the operation of a business presumptively shields the personal assets of the owners/shareholders from the claims of the business's creditors.[3] A court may be asked to ignore this liability shield when a voluntary or involuntary creditor[4] finds the corporation unable to pay its debts.[5] The creditor would like the court to disregard or "pierce" the statutory limited-liability shield so that the debts might be satisfied out of the owners/shareholders' assets, personal or otherwise.[6] Absent a judicial decision to "pierce the corporate veil" in this manner, the limited liability created by the applicable corporate statute stays intact and the creditor must shoulder the loss.

The initial quote above by Justice Benjamin Cardozo in 1926 in a piercing case was prophetic: the concept of "piercing the corporate veil" has become largely divorced from, and ignorant of, both the purposes

1. Berkey v. Third Ave. Ry., 155 N.E. 58, 61 (N.Y. 1926) (Cardozo, J.).

2. Robert Charles Clark, *Corporate Law* 38 (1986).

3. *See, e.g.*, Revised Model Bus. Corp. Act § 6.22(b) (1996) ("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 . . . ."). *See generally* John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 Geo. Wash. L. Rev. 1, 5–9 (1996).

4. "Involuntary creditor" will be used throughout this Article to mean those creditors who did not enter into a debtor-creditor relationship of their own free will. The clearest example of this category would be a person against whom the limited liability entity (LLE) committed some tortious act, such as negligent injury of a pedestrian by a company delivery-truck driver.

5. *See generally* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036 (1991).

6. The theory of piercing applies both to the situation where the owner or owners are individuals and where the owner is another entity, typically a corporation with a wholly owned subsidiary.

behind limiting liability and the legitimate reasons for disregarding that limit. The second quote, from Dean Robert Clark of Harvard Law School sixty years later, confirms Cardozo's prophecy and is a fair assessment of the state of this area of the law today.

That the piercing doctrine is lost in a fog is generally recognized.[7] Courts will pierce the corporate veil, subjecting business owners to potentially ruinous liabilities because the corporation did not observe irrelevant procedures enacted only to protect shareholders[8] or because owners exercised control over corporations commensurate with their ownership interest.[9] In one recent case, the trial court justified its decision to pierce the corporate veil on the mere ground that the sole shareholder signed a piece of corporate letterhead—as president—acknowledging the corporation's debt.[10]

This desultory state of the common law would itself be reason enough for clarification or reform. Business owners have never had much guidance regarding what activities will result in a loss of limited liability. The stakes are much more significant today, however, as presumptive limited liability for business owners has become the norm through the proliferation of new forms of limited liability entities (LLEs).[11] The issue of when limited liability will be lost must now be addressed for these new forms of LLEs as well as for corporations. As if the vagaries of the piercing doctrine were not enough, the business counsel now faces the specter of a different common-law piercing test being developed for each distinct type of LLE within each state.

7. *See, e.g.*, Phillip I. Blumberg, *The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations* 8 (1983) (suggesting that court decisions are "irreconcilable and not entirely comprehensible"); Clark, *supra* note 2, at 72 ("[T]he courts usually forgo any sustained attempt at a remedial theory or even a coherent exposition of the basis of liability, although descriptive summaries are occasionally attempted."); Frank Easterbrook & Daniel Fischel, *The Economic Structure of Corporate Law* 54–55 (1984) ("[T]ests used by courts—whether a corporation has a 'separate mind of its own,' whether it is a 'mere instrumentality,' and so forth—are singularly unhelpful.").

8. *See, e.g.*, Laya v. Erin Homes, Inc., 352 S.E.2d 93, 99 (W. Va. 1986).

9. *See, e.g.*, Janos v. Murduck, 672 N.E.2d 1021, 1024–25 (Ohio Ct. App. 1996).

10. *See* G & S Elec. v. Soha, No. 18665, 1998 WL 488785 (Ohio Ct. App. Aug. 5, 1998). The trial court actually granted the plaintiff's motion for summary judgment, piercing the corporate veil, but the appellate court reversed and remanded for trial. *See id.* at *2.

11. The term "LLE" will be used throughout this Article to apply universally to those statutorily created entities wherein all the owners are statutorily afforded limited liability. This includes primarily corporations, limited liability companies (LLCs), and limited liability partnerships (LLPs).

The advent of these new forms of LLEs offers an opportunity both to clarify and to simplify this area of the law by shedding new light on the reasons for giving owners limited liability and for taking it away. The widespread acceptance of these new LLE forms dispels the long association between passivity and limited liability, which spawned the convoluted piercing doctrine in the first place. The concept of limited liability becomes understandable as purely a means for promoting commercial activity and its benefits.

Part II of this Article addresses the creation and expansion of both limited liability and the development of the new forms of LLEs. Part III analyzes the tests currently used by courts to determine whether to pierce the limited-liability veil. These tests often consist largely of laundry lists of irrelevant factors that the courts recite without analysis or justification.[12] At best, these "totality of the circumstances" types of analyses reflect a case-by-case assessment of the equities of each individual situation. At worst, they impose onerous burdens on an owner[13] whose only culpable act is the failure of the business. In an attempt to make some sense of the decisions in this area, scholars are left to such devices as cataloguing cases by types of plaintiffs and claims[14] or comparing lists of factors used by the courts.[15]

Part IV proposes a new Model Statute governing when owners of all forms of LLEs lose limited-liability protections. The statute would have universal applicability to corporations as well as other forms of LLEs, such as limited liability partnerships and limited liability companies.[16] The proposed statute would serve as an overlay, applying to each type of

12. The *Laya* court stated:

> Most of the numerous factors listed previously are pertinent primarily to the disregard of formalities requirement, not because it is the more important requirement—it is not—but because it is easier to compile a list of typical corporate formalities than to anticipate and list types of inequitable and unfair consequences which could result from not piercing the corporate veil in a given case.

Laya, 352 S.E.2d at 99.

13. The singular term "owner" will be used throughout the Article, though this analysis will apply equally to multiple owners acting in concert as well.

14. *See, e.g.*, Thompson, *supra* note 5, at 1047–66

15. *See, e.g.*, Mark A. Olthoff, *Beyond the Form—Should the Corporate Veil Be Pierced?*, 64 U. Mo. Kan. City L. Rev. 311, 313–14 (1995).

16. Robert Keatinge recently coined the term "universal statute" to mean a statute that applies across multiple forms of business entity but still relates to the characteristics or operations of those entities. Robert R. Keatinge, *Universal Business Organization Legislation: Will It Happen? Why and When*, 23 Del. J. Corp. L. 29, 32 (1998).

LLE despite the underlying organizational statute and could be adopted at either the state or federal level.[17]

The proposed Model Statute would radically change the jurisprudence of piercing law. Adoption of a single, statutory set of standards for loss of limited liability would bring significant certainty to this area of the law. Courts addressing the issue of piercing for any form of LLE would apply a consistent test, eliminating free-form decisionmaking.

Lack of honesty in form and in substance should be the sole reason[18] for waiving statutory limited liability. The proposed test eliminates limited-liability protection whenever an owner acts in a way that misleads creditors as to the assets available to satisfy the debts of the business. This loss of limited liability will result from the voluntary acts of the owner and in a very real sense can be said to be waived by the owner's actions. More fundamentally, the test will serve as a mechanism by which counselors for small businesses can advise: "Dishonesty in the conduct of your business is the only way you can be personally liable. Conduct your business in an honest manner and you can be assured of the protection of statutory limited liability."

Under the proposed test, an owner waives statutory limited liability by participating in any of three types of activities: (1) fraud; (2) transfers of LLE assets[19] in exchange for property contributed or services rendered by the owner for less than reasonably equivalent value; or (3) distribution of money or other property of the LLE to the owner that renders the LLE insolvent.[20] The circumstances surrounding the particular type of waiver dictate the extent of the owner's liability.

17. There are a variety of factors that would go into this determination. One consideration, commercial uniformity, urges adoption at the federal level, especially as business activity is often undertaken at a national or international level. On the other side, businesses involved in piercing claims are often smaller, local enterprises. Additionally, much can be said for allowing individual states to experiment with variations of the Model Statute.

18. Specific legislative enactments, however, such as environmental-liability laws, may also impose liability directly on the owners. *See, e.g.*, Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601(35), 9607(a)(1) (1994) (making owner of facility where hazardous substance is found responsible for cleanup); Lynda J. Oswald, *Strict Liability of Individuals Under CERCLA: A Normative Analysis*, 20 B.C. Envtl. Aff. L. Rev. 579 (1993).

19. Incurring debt would be considered such a transfer.

20. The transfer of assets or profits might also be made to entities in which the owner has an interest. This standard is not entirely new, but is borrowed in part from the Unif. Fraudulent Conveyances Act (1918) § 4. 7AII U.L.A. 67 (1995). The possible application of concepts developed under fraudulent conveyance law in particular and bankruptcy law in general were well

Part V reviews the operation of the test in greater detail, but it may be briefly summarized at this point. In the first instance, when an owner commits fraud or uses the LLE to commit fraud with respect to any material portion of the assets owned by or available to the LLE's creditors, the owner should be liable for the entire debts of the LLE. Several principles underlying the LLE compel this result: providing confidence to LLE creditors that the assets available for satisfaction of LLE debts actually exist, discouraging fraud in a business setting through somewhat punitive sanctions, and, lastly, making defrauded creditors whole. In addition, the high likelihood that the fraud is causally related to the creditor's harm suggests that creditors need not specifically show that the fraud caused their harm.

Absent fraud, an LLE owner will waive limited-liability protection when the owner transfers assets of the LLE either to the owner or to entities in which the owner has an interest, in exchange for less valuable property or services. Finally, transfers of an LLE's assets to either the owner or to entities in which the owner has an interest that render the LLE unable to pay its debts in the ordinary course of business will also waive the owner's limited liability. Unless the creditor can demonstrate that these payments resulted in the failure of the business, however, the owner is liable only for the excess of a reasonable amount. By limiting the owner's exposure to such finite claims in unreasonable-transfer cases, the test allows creditors some recovery when the owner engages in self-dealing while still acknowledging ordinary business practices.

II. EVOLUTION OF LIMITED LIABILITY FOR BUSINESS OWNERS

A. *Limited Liability and Modern Capital Accumulation*

The recognition of the existence of an incorporate person necessarily involves the recognition of the three following principles: (1) a corporation is a person distinct from its members; (2) the property of the corporation is distinct from the property of its members; and (3) the property of its members cannot be taken in execution for the debt of the corporation, and vice versa.[21]

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discussed by Professor Clark before new LLE forms demonstrated the increased applicability of these principles to LLEs. *See* Clark, *supra* note 2, ch. 2.

21. *See* 3 William Holdsworth, *A History of English Law* 482 (1942).

Traditionally, business owners have had to choose between two basic forms of business entities, and in doing so, had to choose between active participation or limited liability. The classic sole proprietorship or general partnership contemplates one or a small group of business owners that actively participate in the business.[22] While they enjoy control over the business, these owners face the prospect of unlimited personal liability for the obligations of the business, except as may be limited by insurance or agreement. The personal assets of sole proprietors and general partners remain unprotected and exposed to attachment by creditors.[23]

In contrast, the traditional advantage of doing business in the corporate form was the ability of business owners/shareholders to limit their personal liability to their actual and promised contributions. Business creditors must look to corporate assets for satisfaction of claims. Creditors generally cannot proceed against the owners' personal assets because the corporate entity shields them from loss.[24]

Generations of business counselors have focused on finding a way to obtain the best of both the partnership and corporate forms. To obtain limited-liability protection, closely held businesses that once might have operated as sole proprietorships or general partnerships began to incorporate.[25] By limiting responsibility for corporate actions to the assets of the corporation while immunizing the owners' personal assets, corporations can attract other owners whose risk of loss is limited by the amount of capital contributed to the corporation.

American law governing corporate limited liability, however, has had a contentious history. In the 1800s, Thomas Cooper described limited

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22. *See* Revised Unif. Partnership Act §§ 301, 306, 401, 404, 6 U.L.A. 33–34, 45, 51–52, 58–59 (1995) (providing that all partners are agents of partnership, bear joint and several liability for partnership obligations, share profits and losses equally, have equal rights to manage partnership, and owe each other general fiduciary duties of loyalty); Unif. Partnership Act §§ 9, 15, 18(a), 18(e), 21, 6 U.L.A. 400–01, 456, 526, 608 (1995).

23. *See* Revised Unif. Partnership Act §§ 306–308, 6 U.L.A. 45, 46–47, 49–50 (1995); Unif. Partnership Act §§ 15–16, 6 U.L.A. 456, 501 (1995).

24. *See, e.g.*, Revised Model Bus. Corp. Act § 6.22(b) (1996) ("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 . . . ."); *cf.* Revised Unif. Ltd. Partnership Act § 403 (amended 1985), 6 U.L.A. 177 (1995) (providing that in limited partnership only general partners are personally liable for debts to third parties).

25. *See generally* Lawrence E. Mitchell, *Close Corporations Reconsidered*, 63 Tul. L. Rev. 1143, 1147 n.10 (1989) (emphasizing that limited liability is "[the] major reason small business persons choose to incorporate").

liability as a "mode of swindling, quite common and honourable in these United States" and "a fraud on the honest and confiding part of the public."[26] Yet, early in the twentieth century, President Butler of Columbia University acclaimed limited liability as "the greatest single discovery of modern times" and that "even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it."[27]

Until the early to mid-1800s, legislation in both England and the United States imposed strict limits on an owner's ability to incorporate and to receive the benefits of limited liability.[28] Incorporation typically required a special act of Parliament or a state legislature.[29] State legislatures enacting general corporation statutes usually imposed substantial limitations on corporations, including minimum paid-in capital requirements, limited permissible purposes, and limited duration.[30] As corporations began to dominate the economic landscape, however, legislatures have removed nearly all of the original limitations on the ability of corporations to organize and operate.[31]

Following the Industrial Revolution, capital-intensive businesses required substantial expenditures beyond the means of the typical entrepreneur, requiring the infusion of outside investment.[32] Granting limited liability to those who contributed capital encouraged investment because people could invest without risking their full personal net worth. The development of modern capital markets depended on limited liability because, although investors may be willing to risk their entire net worth in businesses they themselves operate, they are not willing—absent limited liability—to invest in businesses that they do not operate or closely monitor. Limited liability continues to enable venture

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26. Herbert Hovenkamp, *Enterprise and American Law 1836–1937*, at 50 (1991) (quoting Thomas Cooper, *Lectures on the Elements of Political Economy* 247, 250 (2d ed. 1830)) (footnote omitted).

27. Stephen B. Presser, *Piercing the Corporate Veil* § 1.01, at 1–5 (1999) (citation omitted).

28. *See* Kenneth K. Luce, *Trends in Modern Corporation Legislation*, 50 Mich. L. Rev. 1291, 1293–94 (1952) (describing how "corporate charters were difficult and expensive to obtain, the fruit of special privilege"); *see also* Morton J. Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. Va. L. Rev. 173, 208–09 (1985) ("It is not usually appreciated that truly limited shareholder liability was far from the norm in America even as late as 1900.").

29. *See* Harry G. Henn & John R. Alexander, *Laws of Corporations* § 12, at 24–25 (3d ed. 1983).

30. *See id.* at 25–26.

31. *See id.* at 26–32.

32. *See generally* Hovenkamp, *supra* note 26, at 49–55 (describing postindustrial era shift toward limited liability for shareholders calculated to facilitate infusion of capital into new businesses).

capitalists and casual investors to invest in diverse enterprises without incurring the excessive costs necessary to monitor each enterprise closely.[33]

Corporate law, while securing limited liability, provides that corporate power must be exercised according to certain mandatory rules that "govern defined issues in a manner that cannot be varied by corporate actors."[34] Most importantly, all corporations presumptively must have a board of directors that acts as the central governance group.[35] The owners/shareholders elect the board of directors that makes business policy and manages the corporate enterprise,[36] resulting in a representative, as opposed to democratic, governance structure.

The grant of limited liability to corporate investors advances economic policies by encouraging a broader base of passive participants in business investment.[37] Current corporate codes separate ownership and control. Traditional thinking linked the limited liability given to investors

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33. *See* Easterbrook & Fischel, *supra* note 7, at 41–42. (reasoning that limited liability encourages investor diversification and discourages close monitoring of each individual investment).

34. Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1461 (1989) (footnote omitted); *see* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Colum. L. Rev. 1549, 1553–54 n.16 (1989) (enumerating Delaware's mandatory rules). *But cf.* Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 Colum. L. Rev. 1599, 1599–602, 1616 (1989) (contesting Professor Gordon in part and arguing that although many "mandatory" rules may be avoided, some may be desirable "when externalities are present").

35. *See, e.g.*, Del. Code Ann. tit. 8, § 141(a) (Michie 1991) (stating that board of directors is required unless otherwise provided in certificate of incorporation); Revised Model Bus. Corp. Act §§ 8.01 (establishing that board of directors is required unless all shareholders agree to nontraditional form of governance), 8.03 (stating number and election of directors) (1996).

36. *See, e.g.*, Del. Code Ann. tit. 8, § 141(a); Revised Model Bus. Corp. Act § 8.01 (establishing that business and affairs of corporations shall be managed by or under direction of board of directors). Corporate law requires shareholders to elect the board of directors through regularly scheduled annual elections. *See, e.g.*, Del. Code Ann. tit. 8, § 211(b) (Michie 1991) ("An annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws."); Revised Model Bus. Corp. Act § 7.01(a) (1996) ("A corporation shall hold a meeting of shareholders annually at a time stated in or fixed in accordance with the bylaws."). To provide accountability, perpetual directorships are often banned. *See* Easterbrook & Fischel, *supra* note 7, at 3 (noting that "[s]tates almost uniformly forbid perpetual directorships").

37. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Liability for Corporate Torts*, 100 Yale L.J. 1879, 1879 (1991) (observing that limited liability "create[s] incentives for excessive risk-taking by permitting corporations to avoid the full costs of their activities"); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 Colum. L. Rev. 1565, 1566 (1991) (describing "the traditional corporate and economic justifications for limited liability" as "the need to encourage investment in productive, albeit risky, activities").

with a governance structure in which they were presumptively passive. The directors, not the shareholders, can be held personally liable for their actions in managing the corporation. If a shareholder also serves as a director, personal liability may be imposed for the shareholder/director's actions as a director, not because of his or her status as a shareholder.

B. Double Taxation and the Development of New Forms of LLEs

1. The Kintner *Four-Factor Test*

The main downside with the use of the corporate form has been its unattractive tax treatment. Until 1997, the Internal Revenue Code (Code) created a dichotomy between corporations and partnerships. The Code imposed a two-tier structure of taxation on corporations,[38] while treating partnerships as mere aggregations of their partners not separately taxable as a business entity.[39]

Classifying an entity for tax purposes as either a partnership or a corporation was therefore of central importance to choice-of-entity concerns. Generally, corporations were subject to entity-level taxation while partnerships were entitled to pass-through treatment.[40] Under this treatment, partnership income is attributed to the partners and not the partnership. Thus, the partnership itself is not taxed.[41] Similarly, losses and tax credits also pass through to the partners[42] even in the absence of partnership income or tax on that income.[43]

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38. *See* Boris I. Bittker & James S. Eustice, *The Federal Income Taxation of Corporations and Shareholders* ¶ 1.01, at 1-2 to 1-5 (6th ed. 1994); James S. Eustice et al., *The Tax Reform Act of 1986: Analysis and Commentary* ¶ 2.02 (1987) (discussing history of corporate tax rates); Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale L.J. 90, 90–94 (1977) (discussing development of corporate tax culture and proposing reform package); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 Ind. L.J. 53, 53–55 (1990) (discussing development and significance of corporate excise tax).

39. *See* Robert W. Hamilton, *Fundamentals of Modern Business* 294 (1989) ("Partnerships . . . are not treated as separate taxable entities."); Kimberly K. Francev, *The Fate of the Fully-Divested Lower-Tier Partnership: Does the IRS Recognize the Body?*, 6 DePaul Bus. L.J. 201, 202–07 (1994) (concluding that "partners [are] liable for income tax only in their separate or individual capacities"); Donald J. Weidner, *A Perspective to Reconsider Partnership Law*, 16 Fla. St. U. L. Rev. 1, 4–10 (1988) (comparing entity versus aggregate approach to partnership taxation).

40. *See* Hamilton, *supra* note 39, at 294.

41. *See* I.R.C. § 701 (1994).

42. *See* I.R.C. § 702 (1994).

43. The limitation on the use of passive-activity losses and credits under Code § 469 is applied at the partner level. *See* I.R.C. § 469 (1994), *amended by* Small Business Job Protection Act of 1996,

In contrast, a corporation is subject to double taxation:[44] it is taxed once as an entity,[45] and its shareholders are taxed on distributions of dividends, which are treated as ordinary income.[46] Moreover, because corporate losses do not pass through to the shareholders, such losses cannot be used to offset the shareholders' other income.[47] Retained earnings escape double taxation only temporarily; the profits generated by these retained earnings are taxed at the corporate level.[48] Moreover, these earnings are taxed again at the shareholder level either when they are distributed or when the shares are sold by a shareholder.[49]

Until 1997, the IRS decided whether to impose a double tax on other forms of business organizations on the basis of the organizational characteristics of the particular business. Under treasury regulations adopted in 1960, four attributes or characteristics determined whether a business would be treated as a partnership for federal income tax purposes or as an association subject to the corporate double tax.[50] These attributes, known as the *Kintner* factors,[51] were (1) continuity of life, (2) centralized management, (3) limited liability, and (4) free transferability of interests.[52] To avoid double or entity tax status, a business

Pub. L. No. 104-188, § 1704(d)(1), (e)(1), 110 Stat. 1755, 1878–79 (1996) (codified in scattered sections of 26 U.S.C.) [hereinafter SBJPA of 1996].

44. *See* I.R.C. §§ 301–381 (Subchapter C) (1994) (imposing a double tax on corporations), *amended by* ICC Termination Act of 1995, Pub. L. No. 104-88, § 304(c), 109 Stat. 803, 944, *and* SBJPA of 1996, *supra* note 43, § 1702(h)(7), 110 Stat. at 1874; *cf.* I.R.C. §§ 1361–1375 (1994) (Subchapter S) (imposing single tax on certain closely held corporations), *amended by* SBJPA of 1996, *supra* note 43, 110 Stat. 1755.

45. *See* I.R.C. § 11 (1994).

46. *See* I.R.C. § 61(a)(7) (1994) (establishing that "gross income means all income from whatever source derived, including . . . dividends . . .").

47. *See* Alvin C. Warren, Jr., American Law Inst., *Integration of the Individual and Corporate Income Taxes: Reporter's Study of Corporate Income Tax Integration* 1–12 (1993).

48. *See id.*

49. *See id.* The entity theory was the original basis for imposing a separate corporate tax. *See* Mervyn King, *Public Policy and the Corporation* 50 (1977) (discussing "the concept of separate taxation of the company and its shareholders").

50. *See* Treas. Reg. § 301.7701-2(a)(1) (1960), *replaced by* Check the Box Regulations, Treas. Reg. § 301.7701 (1996). Effective January 1, 1997, the Treasury Department replaced the *Kintner* Regulations, *see infra* notes 51–53 and accompanying text, with the Check the Box Regulations. See *infra* notes 104–11 for a discussion of the Check the Box Regulations.

51. *See* United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).

52. *See* Treas. Reg. § 301.7701-2(a)(1), *replaced by* Check the Box Regulations, Treas. Reg. § 301.7701. The regulations were enacted in response to *Kintner*, which held that an association's tax status was determined by its corporate characteristics. *See Kintner*, 216 F.2d at 418–19. Free transferability of interests exists if each of the owners of the organization—or those owners owning

organization other than a corporation could have no more that two of these characteristics.[53] This four-factor corporate-characteristic test inspired alternative forms of business entities and fueled the adoption of new business entity organization laws that sought both to limit liability and to avoid double taxation.

2. *Efforts to Resolve the Limited-Liability/Double-Tax Dilemma*

The tensions and trade-offs inherent in the quest to achieve limited liability without double taxation have fueled the creation of numerous hybrids of the corporation and the general partnership. These hybrid entities, as attempts at the ideal form of business organization, more or less form a continuum between the pure general partnership and the pure corporation. Although this Article focuses on the main forms of such

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"substantially all" of the interests—has the power, without the consent of other owners, to transfer the ownership interest in a manner that substitutes the transferee for the owner. Treas. Reg. § 301.7701-2(e)(1) (1960), *replaced by* Check the Box Regulations, Treas. Reg. § 301.7701. Such consent may take the form of consent by a majority of owners or consent by a particular owner. *See, e.g.*, Rev. Rul. 93-92, 1993-2 C.B. 318, 320–21 (concluding that Oklahoma limited liability company lacked free transferability of interests because transfer required consent of majority of remaining capital interests). The regulations make clear that free transferability of interests exists only when it is possible to transfer all the rights of the interest owner. *See* Treas. Reg. § 301.7701-2(e) (1960), *replaced by* Check the Box Regulations, Treas. Reg. § 301.7701. If the owner may freely transfer only economic rights, free transferability is not present. *See* Treas. Reg. § 301.7701-2(e), *replaced by* Check the Box Regulations, Treas. Reg. § 301.7701. Revenue Procedure 95-10 follows this division by stating that the IRS will generally rule that free transferability of interests is lacking when a member does not have the power to transfer "all the attributes" of the member's interest without consent. Rev. Proc. 95-10 § 5.02(2), 1995-1 C.B. 501, 504.

53. *See* Treas. Reg. § 301.7701-2(a)(3) (1960), *replaced by* Check the Box Regulations, Treas. Reg. § 301.7701. This four-factor test originated in *Morrissey v. Commissioner*, 296 U.S. 344, 345, 359–60 (1935), which involved the federal income tax classification of an organization formed as a trust under state law. The Supreme Court in *Morrissey* emphasized the trust's freely transferable "share certificates," and it ruled that the trust resembled a corporation and therefore should be classified as an association taxable as a corporation. *Id.* at 360. The Court based its decision on the various characteristics that distinguish associations taxable as corporations from trusts and partnerships, hinging tax classification on the structural and operational resemblance of the subject entity rather than on any policy goal that might be achieved by the classification. *See id.* at 360–61.

In *Kintner*, a physician formed an association of physicians under the rubric of a general partnership, seeking association classification taxable as a corporation, thus enabling the organization to establish a qualified corporate pension plan for the benefit of its employees. *See Kintner*, 216 F.2d at 418–19. The Court of Appeals for the Ninth Circuit held that the organization had sufficient corporate characteristics to qualify as an association taxable as a corporation and therefore the organization was able to avail itself of the benefits of corporate pension tax law. *See id.* at 428.

The Treasury responded to *Kintner* by proposing new regulations in 1959 that were modified and adopted in 1960 as final regulations. *See* T.D. 6503, 1960-2 C.B. 409–25.

alternative entities, only the creativity and risk adversity of the crafter limit the potential variations. The acceptance of these new forms has caused the gradual relaxation of the restrictions that once required business owners to be passive investors to obtain limited liability.

a. S Corporations

Congress adopted Subchapter S to address the double-tax/limited-liability dilemma by affording certain small business corporations partnership-like tax treatment.[54] Congress also believed that Subchapter S would reduce the tax law's impact on the choice of business form.[55] Although S corporations receive the benefit of pass-through taxation, they must give up some of the flexibility the corporate form affords.[56] S-corporation status restricts the number and identity of permissible shareholders[57] and imposes a "one class of stock" ownership requirement.[58] Thus, the resulting regulations restrict the availability of conduit

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54. *See* S. Rep. No. 85-1983, at 68 (1958), *reprinted in* 1958-3 C.B. 922, 1008–09. In August 1996, the Small Business Job Protection Act became law. *See* SBJPA of 1996, *supra* note 43, 110 Stat. 1755. The SBJPA of 1996 was effective beginning January 1, 1997. *See* SBJPA of 1996, *supra* note 43, 110 Stat. 1755.

55. *See* Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. Cin. L. Rev. 1083, 1086–87 (1992).

56. *See* I.R.C. §§ 1361–1378 (1994), *amended by* SBJPA of 1996, *supra* note 43, 110 Stat. 1755.

57. *See* I.R.C. § 1361(b)(1)(A)–(C), *amended by* SBJPA of 1996, *supra* note 43, §§ 1301, 1316(a)(1), 110 Stat. at 1785–86. Prior to enactment of the SBJPA of 1996, in order to qualify for S-corporation tax treatment, a corporation could not have more than 35 shareholders. *See* I.R.C. § 1361(b)(1)(A), *amended by* SBJPA of 1996, *supra* note 43, § 1301, 110 Stat. at 1777. The SBJPA of 1996 increases the maximum number of eligible shareholders from 35 to 75. *See* SBJPA of 1996, *supra* note 43, § 1301, 110 Stat. at 1777. An S corporation may not have a shareholder—other than a trust—who is not an individual. *See* I.R.C. § 1361(b)(1)(B), *amended by* SBJPA of 1996, *supra* note 43, § 1316(a)(1), 110 Stat. at 1785–86. Similarly, the corporation may not have owners who are nonresident aliens. *See* I.R.C. § 1361(b)(1)(C). This limitation poses significant barriers for offshore joint ventures.

58. *See* I.R.C. § 1361(b)(1)(D). S corporations may not be members of affiliated groups and may not have more than one class of stock. *See* I.R.C. § 1361(b)(1)(D), (2)(A), *amended by* SBJPA of 1996, *supra* note 43, § 1308(a), 110 Stat. at 1782. The restrictions limit estate-planning options. With S corporations, it is impossible to create two classes of stock having different management and dividend rights for parent and child. *See* I.R.C. § 1361(b)(1)(D). The restrictions also cause problems when investors contribute different types of assets or have different investment expectations. For example, with S corporations it is impossible to create one class of stock paying fixed high dividends and another class of stock paying low dividends but enjoying capital appreciation. *See* I.R.C. § 1361(b)(1)(D); Richard L. Parker, *Corporate Benefits Without Corporate Taxation: Limited Liability Company and Limited Partnership Solutions to the Choice of Entity Dilemma*, 29 San Diego L. Rev. 399, 421 n.103 (1992).

taxation by adding another level of relatively arbitrary organizational attributes that a business must meet to satisfy the Subchapter S criteria.[59]

The Small Business Job Protection Act of 1996 (SBJPA of 1996),[60] among other things, increased the maximum number of eligible shareholders from thirty-five to seventy-five,[61] allowed "electing small business trust[s]" to hold S-corporation stock,[62] and allowed S corporations to own eighty percent or more of other corporations.[63] Although an improvement, these changes left untouched the basic problems. First, while expanding the potential applicability of Subchapter S, the changes did not lessen the complexity of tax law as applied to these businesses. Second, an opportunity for simplification was lost because the tax consequences of operating a business under Subchapter S for corporations and Subchapter K for partnerships still differ. More fundamentally, business owners would still be encouraged to choose their entity classification so as to produce the lowest tax bill, regardless of whether or not that entity provides the optimal organizational structure for the business.[64]

b. Limited Partnerships and Master Limited Partnerships

New York ushered in the first limited partnership statute in 1822[65] and soon other jurisdictions began adopting this business form. In 1916, the Commissioners on Uniform State Laws drafted the Uniform Limited Partnership Act, which was subsequently enacted by nearly every state.[66] In 1976, the Commissioners on Uniform State Laws approved a Revised Uniform Limited Partnership Act, which most jurisdictions have adopted.[67]

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59. *See* Parker, *supra* note 58, at 421 n.103.

60. Pub. L. No. 104-188, 110 Stat. 1755 (codified in scattered sections of 26 U.S.C.). Sections 1301 to 1317 of the SBJPA of 1996 amended the Subchapter S rules.

61. *See* SBJPA of 1996, *supra* note 43, § 1301, 110 Stat. at 1777.

62. SBJPA of 1996, *supra* note 43, § 1302, 110 Stat. at 1777.

63. *See* SBJPA of 1996, *supra* note 43, § 1308, 110 Stat. at 1782–83.

64. In addition, the eligibility requirements would continue to be different. Some investors who would otherwise prefer the corporate form would be forced to adopt a partnership or limited liability company structure in order to obtain the desired tax consequences.

65. *See* Unif. Ltd. Partnership Act (1916) § 1 official cmt., 6A U.L.A. 313 (1995).

66. *See* R. Kurt Wilke, Note, *Limited Partnership Control: A Reexamination of Creditor Reliance*, 60 Ind. L.J. 515, 518 (1985). Louisiana is the exception. *See id.*

67. *See* Deborah A. DeMott, *Our Partners' Keepers? Agency Dimensions of Partnership Relationships*, L. & Contemp. Probs., Spring 1995, at 115 (Deborah A. DeMott & J. Dennis Hynes eds.).

A hybrid between the classic general partnership and the corporation, a limited partnership has at least one general partner, who, like all partners in a regular general partnership, must have unlimited liability.[68] The rest of the partners can be limited partners who do not have personal liability for the debts of the enterprise.[69] Generally, a limited partnership has been taxed as a partnership if it lacked at least two of the four *Kintner* factors.[70] This treatment persists even though the general partners can actively manage the business. The limited partners, in contrast, can exercise only limited control over the partnership and have no day-to-day control over the partnership's business.[71]

In essence, the premise for allowing corporate limited liability is continued in the limited partnership. Limited partners, like shareholders in the corporation, have no management rights and no personal liability. They trade their involvement in management for the security of limited liability. General partners, on the other hand, like directors and officers of a corporation, have management authority but also commensurate personal liability.

The pass-through treatment of the limited partnership catalyzed the emergence of "master limited partnerships": large, syndicated, publicly traded tax-shelter limited partnerships[72] in which the equity participants enjoyed limited liability.[73] The limited partnerships generally obtained favorable pass-through treatment of income, gains, and losses by avoiding "association" classification under the *Kintner* regulations.[74] Fearing abuse and unrestrained growth of tax-shelter limited partnerships,

68. *See* Revised Unif. Ltd. Partnership Act §§ 101(7), 303 (amended 1985), 6A U.L.A. 144–45 (1995).

69. *See* Revised Unif. Ltd. Partnership Act §§ 101(7), 303, 6A U.L.A. 144–45.

70. *See* Larson v. Commissioner, 66 T.C. 159, 185–86 (1976) (Dawson, C.J., concurring), *acq.* 1979-2 C.B. 2; Treas. Reg. §§ 301.7701-2(a)(3), -3(b)(1) (1960). In *Larson*, the court held that an entity organized as a limited partnership that possessed the corporate characteristics of centralized management and free transferability of interests, but lacked continuity of life and limited liability, was taxable as a partnership. *See Larson*, 66 T.C. at 185–86 (Dawson, C.J., concurring).

71. *See* Revised Unif. Ltd. Partnership Act § 303, 6A U.L.A. 144–45. A limited partner's relationship to the partnership mirrors a shareholder's relationship to a corporation. *See* Revised Unif. Ltd. Partnership Act § 303, 6A U.L.A. 144–45. During the 1970s and 1980s, limited partnerships became the principal vehicle for tax shelter investors. *See* Richard A. Booth, *Profit-Seeking, Individual Liability, and the Idea of the Firm*, 73 Wash. U. L.Q. 539, 546 (1995).

72. For a discussion of the creation of the limited partnership association, see Edward R. Schwartz, *The Limited Partnership Association—An Alternative to the Corporation for the Small Business with "Control" Problems?*, 20 Rutgers L. Rev. 29, 29–64 (1965).

73. As to the limited liability of the limited partners in a large limited partnership, see Revised Unif. Ltd. Partnership Act § 303, 6A U.L.A. 144–45.

74. *See* Treas. Reg. §§ 301.7701-2(a)(3), -3(b)(1).

Congress finally addressed the problem in 1987 with the enactment of Code § 7704,[75] which reclassified most publicly traded limited partnerships as corporations for tax purposes.[76] The life-and-death saga of the master limited partnership provides a classic example of the intrinsic dangers and frailty of a Treasury- and IRS-dictated organizational regime: with one pen stroke the Treasury and the IRS eliminated the tax advantages of the master limited partnership, leaving individuals who had relied on this structure with hefty tax bills.

All in all, however, the standard limited partnership was only a partial solution in the search for the perfect form of business organization. While limited partners in small limited partnerships could enjoy the security of limited liability, a general partner still remained subject to unlimited liability. In addition, the traditional connection between management authority and personal liability continued.

c. Limited Liability Companies

As the next step in the development of business organization law, the limited liability company (LLC) represented a significant step in the breakdown of the trade-off of investor passivity for limited liability. Causing a minor business revolution over the past decade, the LLC was created out of whole cloth solely to satisfy the limited liability/double taxation conundrum.

In 1977, Wyoming adopted the first modern[77] LLC act in the United States, creating a new form of business entity that would provide both limited liability and federal pass-through partnership-like income tax

75. *See* Pub. L. No. 100-203, § 10211(9), 101 Stat. 1330–403 (1987) (codified as amended at I.R.C. § 7704 (1994)) (reclassifying certain publicly traded partnerships as corporations); *see also* H.R. Rep. No. 100-495, at 947–50 (1987) (discussing classification and treatment of publicly traded partnerships).

76. *See* I.R.C. § 7704 (1994); *see also* I.R.S. Notice 88-75, 1988-2 C.B. 386 (defining publicly traded partnership and setting forth transition rules for existing partnership in accordance with § 7704); Sheldon I. Banoff, *Avoiding Publicly Traded Partnership Status: Living and Dying with Notice 88-75*, 66 Taxes 561 (1988) (advising how to avoid publicly traded partnership status under new IRS guidelines).

77. The limited partnership association, adopted in Pennsylvania, Michigan, New Jersey, and Ohio in the 1870s, was arguably the LLC's unsuccessful ancestor. *See* Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 Case W. Res. L. Rev. 387, 393–94 (1991). In fact, the 1977 Wyoming statute utilized some language from the Ohio limited partnership association statute. *See id.* at 395.

treatment.[78] Florida followed with LLC legislation in 1982.[79] In 1982, the IRS began a study of the LLC and suspended the further issuance of private letter rulings concerning the classification of LLCs as partnerships for federal income tax purposes.[80]

Initial concerns about the federal income tax classification of LLCs were laid to rest with the completion of the IRS study and issuance in 1988 of a landmark revenue ruling granting a favorable partnership classification for the Wyoming LLC.[81] With the tax consequences of the LLC more assured, Colorado and Kansas started the second wave of LLC legislation by enacting statutes in 1990.[82] Four states enacted LLC statutes in 1991,[83] ten did so in 1992,[84] twenty adopted legislation in

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78. *See* Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 537 (codified as amended at Wyo. Stat. Ann. §§ 17-15-101 to -144 (Lexis 1999)); Philip P. Whynott, *North American Trade Treaty Stimulates Interest in U.S. LLCs: A Historical Update*, 1 Limited Liability Company Rep. 93-106, 93-106 to -107 (1993). The LLC concept was introduced in Germany in 1892 by a law authorizing the formation of the private limited company, the *Gesellschaft mit beschrankter Haftung* ("GmbH," or LLC). *See* Kristin A. DeKuiper, *The European Limited Liability Company—A Comparison of the Czech, Slovak and German Examples with the New American Entity*, 1 Parker Sch. J. E. Eur. L. 291, 291 (1994).

79. *See* Richard Johnson, Comment, *The Limited Liability Company Act*, 11 Fla. St. U. L. Rev. 387, 387 (1983).

80. *See* Gazur & Goff, *supra* note 77, at 445.

81. *See* Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

82. *See* Colorado Limited Liability Company Act, ch. 58, 1990 Colo. Sess. Laws 414 (codified as amended at Colo. Rev. Stat. Ann. §§ 7-80-101 to -1101 (West 1999)); Kansas Limited Liability Company Act, ch. 80, 1990 Kan. Sess. Laws 585 (codified at Kan. Stat. §§ 17-7601 to -7656 (1995 & Supp. 1998)).

83. These four states are Nevada, Texas, Utah, and Virginia. *See* Limited Liability Company Act, ch. 442, 1991 Nev. Stat. 1184 (codified as amended at Nev. Rev. Stat. §§ 86.011–.571 (1997)); Limited Liability Company Act, ch. 901, 1991 Tex. Gen. Laws 3161 (codified at Tex. Rev. Civ. Stat. Ann. art. 1528n (West 1997)); Utah Limited Liability Company Act, ch. 258, 1991 Utah Laws 991 (codified as amended at Utah Code Ann. §§ 48-2b-101 to -158 (Michie 1994 & Lexis Supp. 1998)); Virginia Limited Liability Company Act, 1991 Va. Acts, ch. 168 (codified at Va. Code Ann. §§ 13.1-1000 to -1073 (Michie 1999)).

84. These 10 states are Arizona, Delaware, Illinois, Iowa, Louisiana, Maryland, Minnesota, Oklahoma, Rhode Island, and West Virginia. *See* Act of June 2, 1992, ch. 113, 1992 Ariz. Sess. Laws 394 (codified at Ariz. Rev. Stat. Ann. §§ 29-601 to -857 (West 1998)); Act Effective Oct. 1, 1992, ch. 434, 68 Del. Laws 1329 (1992) (codified as amended at Del. Code Ann. tit. 6, §§ 18-101 to -1109 (Michie 1999)); Limited Liability Company Act, Public Act 87-1062, 1992 Ill. Laws 2529 (codified at 805 Ill. Comp. Stat. Ann. §§ 180/1-1 to 60-1 (West Supp. 1999)); Iowa Limited Liability Company Act, ch. 1151, 1992 Iowa Acts 238 (codified at Iowa Code Ann. §§ 490A.100–.1601 (West 1999)); Limited Liability Company Law, No. 780, 1992 La. Acts 2083 (codified as amended at La. Rev. Stat. Ann. §§ 12:1301 to :1369 (West 1994 & Supp. 2000)); Maryland Limited Liability Company Act, ch. 536, 1992 Md. Laws 3286 (codified as amended at Md. Code Ann., Corps. & Ass'ns §§ 4A-101 to -1103 (Lexis 1999)); Minnesota Limited Liability Company Act, ch. 517, 1992 Minn. Laws 1168 (codified as amended at Minn. Stat. Ann. §§ 322B.01–.960 (West 1995 & Supp.

1993,[85] ten in 1994,[86] and one additional state adopted LLC legislation in 1995.[87] Presently, forty-eight states have some version of LLC legislation.[88]

2000)); Oklahoma Limited Liability Company Act, ch. 148, 1992 Okla. Sess. Laws 483 (codified at Okla. Stat. Ann. tit. 18, §§ 2000–2060 (West 1999 & Supp. 2000)); Rhode Island Limited Liability Company Act, ch. 280, 1992 R.I. Pub. Laws 1108 (codified as amended at R.I. Gen. Laws §§ 7-16-1 to -75 (1992 & Supp. 1998)); Uniform Limited Liability Company Act, 1996 W. Va. Acts 256 (codified at W. Va. Code §§ 31B-1-101 to -13-1306 (1996)).

85. These 20 states are Alabama, Arkansas, Connecticut, Florida, Georgia, Idaho, Indiana, Maine, Michigan, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Oregon, South Dakota, and Wisconsin. *See* Alabama Limited Liability Company Act, No. 724, 1993 Ala. Acts 1425 (codified at Ala. Code §§ 10-12-1 to -61 (Lexis 1999)); Small Business Entity Pass Through Act, No. 1005, 1993 Ark. Acts 2928 (codified at Ark. Code Ann. §§ 4-32-101 to -1316 (Michie 1996 & Lexis Supp. 1999)); Connecticut Limited Liability Company Act, No. 267, 1993 Conn. Acts 884 (Reg. Sess.) (codified at Conn. Gen. Stat. Ann. §§ 34-100 to -242 (West 1997 & Supp. 1999)); Florida Limited Liability Company Act, 1993 Fla. Laws, ch. 284 (codified at Fla. Stat. Ann. §§ 608.401–.703 (West 2000)); Georgia Limited Liability Company Act, No. 174, 1993 Ga. Laws 123 (codified as amended at Ga. Code Ann. §§ 14-11-100 to -1109 (Michie 1994 & Lexis Supp. 1999)); Idaho Limited Liability Company Act, ch. 224, 1993 Idaho Sess. Laws 760 (codified as amended at Idaho Code §§ 53-601 to -672 (Michie 1994 & Lexis Supp. 1999)); Indiana Business Flexibility Act, P.L. 8, 1993 Ind. Acts 1694 (codified as amended at Ind. Code Ann. §§ 23-18-1-1 to -13-1 (Lexis 1999 & Supp. 1999)); Maine Limited Liability Company Act, ch. 718, 1993 Me. Laws 2168 (codified at Me. Rev. Stat. Ann. tit. 31, §§ 601–762 (West 1996)); Michigan Limited Liability Company Act, No. 23, 1993 Mich. Pub. Acts 138 (codified at Mich. Comp. Laws Ann. §§ 450.4101–.5200 (West Supp. 1999)); Missouri Limited Liability Company Act, 1993 Mo. Laws 965 (codified at Mo. Ann. Stat. §§ 347.010–.740 (West Supp. 1999)); Montana Limited Liability Company Act, ch. 120, 1993 Mont. Laws 269 (codified at Mont. Code Ann. §§ 35-8-101 to -1307 (1999)); Limited Liability Company Act, LB 121, 1993 Neb. Laws 333 (codified as amended at Neb. Rev. Stat. Ann. §§ 21-2601 to -2653 (Lexis 1999)); Act of June 23, 1993, ch. 313, 1993 N.H. Laws 323 (codified at N.H. Rev. Stat. Ann. §§ 304-C:1 to :85 (Michie 1995 & Lexis Supp. 1999)); New Jersey Limited Liability Company Act, ch. 210, 1993 N.J. Laws 1215 (codified at N.J. Stat. Ann. §§ 42:2B-1 to -70 (West Supp. 1999)); Limited Liability Company Act, ch. 280, 1993 N.M. Laws 2753 (codified as amended at N.M. Stat. Ann. §§ 53-19-1 to -74 (Michie 1993 & Supp. 1999)); North Carolina Limited Liability Company Act, ch. 354, 1993 N.C. Sess. Laws 1080 (codified at N.C. Gen. Stat. §§ 57C-1-01 to -10-07 (Michie 1993 & Lexis Supp. 1999)); North Dakota Limited Liability Company Act, ch. 92, 1993 N.D. Laws 390 (codified at N.D. Cent. Code §§ 10-32-01 to -156 (Michie 1995 & Lexis Supp. 1999)); Oregon Limited Liability Company Act, ch. 173, 1993 Or. Laws 435 (codified at Or. Rev. Stat. §§ 63.001–.990 (1997)); Act of March 13, 1993, ch. 344, 1993 S.D. Laws 535 (codified at S.D. Codified Laws §§ 47-34-1 to -59 (Lexis Supp. 1999)); Act of December 14, 1993, ch. 112, 1993 Wis. Laws 708 (codified at Wis. Stat. Ann. §§ 183.0102–.1305 (West Supp. 1999)).

86. These 10 states are Alaska, California, Kentucky, Mississippi, New York, Ohio, Pennsylvania, South Carolina, Tennessee, and Washington. *See* Alaska Revised Limited Liability Act, 1994 Alaska Sess. Laws 99 (codified at Alaska Stat. §§ 10.50.010–.995 (Lexis 1998)); Beverly-Killea Limited Liability Company Act, 1994 Cal. Stat. 1200 (codified at Cal. Corp. Code §§ 17000–17705 (West Supp. 1998)); Kentucky Limited Liability Company Act, ch. 389, 1994 Ky. Acts 1087 (codified at Ky. Rev. Stat. Ann. §§ 275.001–.455 (Banks-Baldwin Supp. 1999)); Mississippi Limited Liability Company Act, ch. 402, 1994 Miss. Laws 215 (codified at Miss. Code Ann. §§ 79-29-101 to -1204 (West 1999)); New York Limited Liability Company Act, ch. 576, 1994 N.Y. Laws 1347

Balancing limited liability with pass-through taxation, the LLC represents a new hybrid to the business entity montage. Unlike a limited partnership, in which a general partner has personal liability to third parties for the recourse debts of the partnership,[89] all owners of an LLC enjoy limited liability—no owner bears personal responsibility for LLC debts.[90] Moreover, many LLC codes derive from a partnership organizational framework,[91] with presumptive management by the owners/members. LLC statutes reflect both the form of entity that the parties would have ultimately chosen[92] and the need to ensure the classification of the LLC as a partnership for federal income tax purposes. To achieve this, LLC statutes typically allow multiple members,[93] the potential for dissolution upon the death or withdrawal of

(codified at N.Y. Ltd. Liab. Co. Law §§ 101–1403 (West Supp. 1999)); Act Effective July 1, 1994, 1994 Ohio Laws 634 (codified at Ohio Rev. Code Ann. §§ 1705.01–.58 (Anderson 1997 & Supp. 1998)); Limited Liability Company Law of 1994, No. 106, 1994 Pa. Laws 703 (codified at 15 Pa. Cons. Stat. Ann. §§ 8901–8998 (West 1995 & Supp. 1999)); South Carolina Limited Liability Company Act, No. 448, 1994 S.C. Acts 4856 (codified at S.C. Code Ann. §§ 33-43-101 to -1409 (West Supp. 1999)); Tennessee Limited Liability Company Act, ch. 868, 1994 Tenn. Pub. Acts 654 (codified at Tenn. Code Ann. §§ 48-201-101 to -248-602 (Michie 1995 & Lexis Supp. 1999)); Washington Limited Liability Company Act, ch. 211, 1994 Wash. Laws 1018 (codified at Wash. Rev. Code §§ 25.15.005–.902 (1998)).

87. Massachusetts enacted an LLC statute effective January 1, 1996. *See* Massachusetts Limited Liability Company Act, 1995 Mass. Acts 281 (codified at Mass. Ann. Laws, ch. 156C, §§ 1–68 (Law Co-op. 1996)).

88. *See supra* notes 78, 82–87. Hawaii's LLC statute became effective April 1, 1997. *See* Hawaii Limited Liability Company Act, 1996 Haw. Sess. Laws 92 (codified at Haw. Rev. Stat. Ann. §§ 428-101 to -1302 (Lexis Supp. 1999)).

89. *See* Revised Unif. Ltd. Partnership Act § 303 (amended 1985), 6A U.L.A. 144–45 (1995).

90. *See, e.g.*, Md. Code Ann., Corps. & Ass'ns § 4A-301 (Lexis 1999) ("Except as otherwise provided ... no member shall be personally liable for the obligations of the limited liability company...."); N.J. Stat. Ann. § 42:2B-23 (West Supp. 1996) ("Except as otherwise provided... the debts, obligations and liabilities of a limited liability company, whether arising in contract, tort or otherwise shall be solely the debts, obligations and liabilities of the limited liability company ... no member ... shall be obligated personally....").

91. For a bibliography of LLC literature, see Daniel J. Jacobs, *Limited Liability Companies (LLCs): A Selective Bibliography with Statutory References*, 49 Rec. Ass'n B. City N.Y. 901 (1994). *See also* Gazur & Goff, *supra* note 77 (assessing the LLC form); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 Bus. Law. 375 (1992) (comparing LLCs to other business organization forms and analyzing state LLC statutes).

92. *See, e.g.*, Scott R. Anderson, *The Illinois Limited Liability Company: A Flexible Alternative for Business*, 25 Loy. U. Chi. L.J. 55, 103 (1993) ("LLCs, particularly member-managed LLCs, are likely to be closely held....").

93. Several states—including Arkansas, Colorado, Georgia, Idaho, Indiana, Missouri, Montana, New Mexico, New York, and Texas—permit one-member LLCs, although the federal income tax classification of one-member LLCs remains uncertain. *See generally* Larry E. Ribstein & Robert R. Keatinge, *Ribstein and Keatinge on Limited Liability Companies* § 16.19 (1995). The IRS will

a member,[94] and the limitations on the transferability of ownership interests, all to ensure the desired partnership income tax classification under the Code.[95]

This is not to say that the various LLC statutes follow a single pattern or even that they will be a continuing force as a form of business entity.[96] In fact, the emergence of the LLC does not represent a simplification of business organization law; ongoing experimentation by legislative, judicial, regulatory, and practitioner fiat will result in a complex array of laws that simultaneously revisit issues already settled in other contexts and address these issues anew.[97]

The common link in each of the LLC statutes, however, is either presumptive or optional management by the owners. The concept of separating management authority and structure from limited liability is gone. The LLC exemplifies a crossroads in the development of business organization law. No longer is managerial passivity the price that must be paid for limited liability.

d. Limited Liability Partnerships

The development of the "limited liability partnership" or "registered limited liability partnership" (jointly LLP) as the newest form of LLE highlights the breakdown of the final barriers between passive investors and active managers. An LLP is first and foremost a general partnership wherein the partners both own and manage the business. Like the general

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consider a ruling request regarding classification of an LLC as a partnership for federal tax purposes only if the LLC has at least two members. *See* Rev. Proc. 95-10, § 4.01, 1995-1 C.B. 501, 502.

94. Although most of the LLC statutes use the term "dissolution," the term "dissociation" was introduced in the Revised Unif. Partnership Act § 601, 6 U.L.A. 72–74 (1995). "Dissociation" is also the term used in the Unif. Ltd. Liab. Co. Act § 601, 6A U.L.A. 471–72 (1995).

95. *See* Susan P. Hamill, *The Limited Liability Company: A Midpoint Evaluation*, 52d Inst. Fed. Tax'n 1-1, § 1.02 (1994) (discussing classification of LLCs as partnerships).

96. *See, e.g.*, Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 Am. J. Tax Pol'y 13, 47 (1995).

97. Professor Rands states that the LLC's "emergence is an example of badly formulated tax law," stressing that "the germinal point in the history of limited liability companies was the issuance of Revenue Ruling 88-76, which interprets the long outdated *Kintner* Regulations and applies them to a Wyoming state statute!" William J. Rands, *Passthrough Entities and Their Unprincipled Differences Under Federal Tax Law*, 49 SMU L. Rev. 15, 32 (1995) (footnote omitted). Professor Rands concludes that, at best, LLCs are a marginal improvement over current limited partnerships and are less desirable than corporations inasmuch as LLCs are fraught with uncertainty. *See id.* at 36–37 (noting uncertainties regarding, among others, veil piercing, fiduciary duties, and member requirements).

partnership, there is no separation between the partners' roles as investors and as managers. Almost as an aside, LLP statutes usually contain a one-paragraph provision restricting the limited liability of a LLP's owners if appropriate documentation is filed with the state.

The liability protection accorded LLP owners is not always as extensive as that accorded their corporate counterparts.[98] Some statutes restrict the protection to limiting partners' personal liability for the liabilities of copartners, without affecting liability for obligations of the partnership.[99] Other statutes protect partners only against liability for tort debt, but not contract debt.[100] In still other states, LLP amendments to the general partnership laws have been adopted, limiting liability for all types of activities and for all partnership obligations.[101] The IRS has ruled that LLPs are partnerships for federal income tax purposes despite such limited liability.[102]

By combining limited liability for general partners with the well-established partnership law foundation, LLP legislation produced renewed interest in the partnership form. The LLP is the perfect solution for participants seeking a partnership structure with active control, but with limited liability. Any thought of having to forego active involvement in the business in order to obtain the protection of limited liability has been eliminated. In some sense, the LLP has become the

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98. Some of the LLP statutes apply only to partnerships of persons rendering professional services. *See, e.g.*, Cal. Corp. Code §§ 15001–15800 (West Supp. 1998) (limiting LLPs to accountants and attorneys); Or. Rev. Stat. § 68.110 (1995) (limiting LLPs to defined professions). *But see* Nev. Rev. Stat. Ann. § 87.020.7 (Michie 1995) (stating that LLPs are not limited to professional services); N.Y. Partnership Law § 121-1500(a) (West Supp. 1999) (establishing that LLPs are not limited to professional services).

99. *See, e.g.*, Va. Code Ann. § 50-15(2)(B)–(C) (Lexis Supp. 1998) (repealed effective Jan. 1, 2000). Under the Virginia statute, a partner is not liable for "debts, obligations and liabilities . . . arising from negligence, malpractice, wrongful acts or misconduct committed . . . by another partner, employee, agent or representative [of the partnership]." Va. Code Ann. § 50-15(2)(B). A partner is, however, liable "for his own negligence, malpractice, wrongful acts or misconduct, or for the negligence, malpractice, wrongful acts or misconduct of any employee, agent or representative acting under his direct supervision and control in the specific activity in which the negligence, malpractice, wrongful acts or misconduct occurred." Va. Code. Ann. § 50-15(2)(C).

100. *See, e.g.*, Tex. Rev. Civ. Stat. Ann. art. 6132b, § 15 (West 1995).

101. *See, e.g.*, Minn. Stat. Ann. § 323.14 (West 1999); N.Y. Partnership Law § 26(b) (West Supp. 1999); *see also* Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. Colo. L. Rev. 1065, 1087–102 (1995) (discussing Minnesota's and New York's LLP statutes).

102. *See* Rev. Rul. 95-55, 1995-2 C.B. 313 (concluding that New York LLP is classified as partnership for federal tax purposes).

perfect business form: limited liability for all owners, pass-through tax status, and full management authority residing in the owners.

3. *The Demise of the* Kintner *Regime*

The tax-driven strictures of the *Kintner* regulations spawned LLPs and LLCs in virtually every state,[103] thereby necessitating the creation of a whole new body of law with all the resulting uncertainty. It was inevitable that something had to change—the lawyers had created two business forms, the LLC and the LLP that provided limited liability while avoiding double taxation.

On December 18, 1996, the Treasury capitulated and finalized its revolutionary "Simplification of Entity Classification Rules," also known as the "Check the Box" regulations, which became effective January 1, 1997.[104] The Check the Box regulations replaced the existing *Kintner* classification regulations with a simplified regime that is elective for certain business organizations. Stressing that under the current system, "taxpayers and the IRS must expend considerable resources on classification issues,"[105] the Treasury and the IRS aimed "to replace the increasingly formalistic rules . . . with a much simpler approach that generally is elective."[106]

The Check the Box Regulations define "corporation" to include any business entity that is formed as a corporation under state law or taxable as a corporation under another provision of the Code.[107] The Check the Box Regulations continue to highlight "publicly traded" status as a determinative factor of corporate classification.[108] The result of these changes is that a business is subject to double tax only if the owners so decide—either by incorporating or going public.

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103. *See supra* notes 77–88 (listing states that have adopted LLC statutes).

104. *See* Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584, 66,584 (1996) (codified at 26 C.F.R. pt. 301).

105. Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,990 (1996) [hereinafter Check the Box Regulations] (proposed May 3, 1996) (noting that "since the issuance of Rev. Rul. 88-76, the IRS has issued seventeen revenue rulings analyzing individual state limited liability company statutes, and has issued several revenue procedures and numerous letter rulings relating to classification of various business organizations").

106. *Id.*

107. *See* Treas. Reg. § 301.7701-2(b) (1996).

108. *See* Treas. Reg. § 301.7704 (1996).

According to the Check the Box Regulations, if a business is incorporated under a state's corporation law, it will be taxed separately from its owners. All other forms of business organizations, including all the other LLE variations, can elect to be classified as an association (with entity tax status) or a partnership (with pass-through tax status).[109] The Check the Box Regulations provide a default rule that approximates owners' expectations more closely by classifying any newly formed business entity other than a corporation as a partnership.[110] Under the Check the Box Regulations, eligible entities that existed prior to the effective date of the regulations and chose to retain their existing classification did not have to file an election.[111]

While the Check the Box Regulations constituted a significant step towards exalting substance over form, the long road that led to rejection of the *Kintner* regime left business organization law with a variety of LLE business forms, some of them brand new in structure and terminology. Today, tax issues aside, LLEs exist so entrepreneurs can engage in a particular business without fear of losing their houses, their possessions, or their other businesses.[112] In this sense, statutes creating LLEs are essential to a healthy marketplace because they encourage newcomers to invest capital and to participate in business.[113] The almost universal adoption of the limited liability company and the limited liability partnership makes clear the states' desire to expand upon this important policy decision.[114] State legislatures around the country, having considered the underlying arguments both for and against limited liability, elected to encourage commercial activity at the possible

109. *See* Treas. Reg. § 301.7701-3(a) (1996). "Eligible entity" is referred to in the regulation as a business entity that is not required to be classified as a corporation under Treas. Reg. § 301.7701-2(b)(3)–(8).

110. *See* Treas. Reg. § 301.7701-3(a). Similarly, if that entity has a single member, it will not be treated as an entity separate from its owner for federal tax purposes unless an election is filed to classify the organization as an association. *See* Treas. Reg. § 301.7701-3(a).

111. *See* Treas. Reg. § 301.7701-3(a).

112. *See* Dwyer v. ING Inv. Co., 889 S.W.2d 902, 904 (Mo. Ct. App. 1994) ("One of the fundamental policies underlying corporation law is the encouragement of business ventures by providing for limited liability.").

113. *See* Clark, *supra* note 2, at 1–34 (noting in general that limited liability encourages investors' entry into market, and that increased interest rates lenders charge to LLEs is efficient method of distributing risk).

114. *See supra* notes 77–88 and 98–102.

expense of creditors and others to whom a particular business may have incurred obligations.[115]

C. *An Opportunity for Reevaluation and Reform*

While limited liability was historically restricted to passive shareholders in a corporation, the expansion of limited liability to LLEs, where such passivity has not been required or expected, suggests the statutory intent to divorce the question of limited liability from the degree to which an investor controls an LLE.[116] Indeed, while the benefits of pass-through taxation certainly contributed to the popularity of the new LLE forms, commentators agree that a major factor in making these entities more attractive to businesses is their combination of flexibility and security.[117]

Corporate limited liability promoted passive investment, but the new LLE forms expect owner involvement in running the business. Because the legislatures' purpose has changed from merely encouraging and protecting passive investors to actively promoting business,[118] the reasons for courts to pierce the corporate veil and disregard the limited liability provided by the LLE form should likewise be reexamined. The test for deciding whether to waive limited liability must be both broadened beyond the mere formalities of corporate proceduralism and narrowed to that evidence demonstrating that limited liability was used in a way contrary to the legislatures' purpose in creating it. The liability

115. Some commentators and courts refuse to acknowledge the purpose reflected in this policy decision. They continue, instead, to emphasize the potential negative effects of limited liability on third parties rather than the positive effects of limited liability on the market. *See, e.g.*, Franklin A. Gevurtz, *Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil*, 76 Or. L. Rev. 853, 853 (1997) (arguing "[l]imited liability means leaving creditors of failed corporations unpaid").

116. This new direction has been completely overlooked by some commentators who have advocated for the application of the same piercing doctrine to LLCs and LLPs as has been applied to corporations. *See* Shaun M. Klein, Comment, *Piercing the Corporate Veil of the Limited Liability Company, from Sure Bet to Long Shot:* Gallinger v. North Star Hospital Mutual Assurance Ltd., 22 J. Corp. L. 131 (1996).

117. *See* William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. Colo. L. Rev. 855, 858 (1995) (suggesting that "[IRS] Ruling 88-76, which provided that a Wyoming LLC could be classified as a partnership for tax purposes... opened the floodgates, and LLC statutes have now been adopted in nearly all the states"). That is, these LLEs need not satisfy the stilted "corporate formalities" requirement to maintain their limited liability status.

118. *See* Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. Corp. L. 573, 604 (1986) (finding that role of, and justification for, limited liability has changed over time and that "[t]he triumph of limited liability flows from concerns of policy").

shield should not be used to protect conduct that runs contrary to the promotion of business.

Any new test should apply equally to all forms of LLEs. Only LLEs with small ownership groups are generally subject to creditors' attempts to reach their owners' personal assets, primarily because it is in these situations that the owners are less likely to follow corporate formalities or to be able to finance the entity with substantial capitalization.[119] Because no substantive differences between these small businesses justify disparate treatment of their statutory limited liability, a single test can address all the potential waiver situations likely to arise. A single test would be easier for courts to administer, would encourage businesses to choose their LLE form for business reasons, and would still avoid the potential injustice of differing results based on different business forms.

The only reason for distinguishing among the three forms of LLEs[120] is the additional operational formalities typically required of corporations. The observance of these corporate formalities is neither a relevant nor useful factor even when the issue of piercing involves a corporation. In almost all cases, the corporation could observe all statutorily required formalities and still take the same action that would lead to the alleged harm.[121] Moreover, the corporate formalities relied upon by courts to disregard limited liability are not intended to protect creditors in the first place.[122] As previously noted, the new LLEs are almost entirely lacking in required formalities.[123] By putting aside issues related to irrelevant formalities requirements, a new test can be applied to all LLE forms, as some LLE statutes envision[124] and as some courts have already done.[125]

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119. *See* Thompson, *supra* note 5, at 1047–66.

120. Corporations, Limited Liability Companies, and Limited Liability Partnerships.

121. *See* Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 Harv. L. Rev. 505 (1977) (arguing inattention to formalities is irrelevant to existence and amount of harm caused to creditor); *see also In re* Tax Indebtedness of Coppola, No. 91-CV-0910 (JBW) 73, 1994 WL 159525 (E.D.N.Y. Jan. 10, 1994) (finding that defendant's observance of corporate formalities precluded summary judgment for government despite uncontested evidence of self-dealing, inadequate capitalization, common offices and personnel, and owners' personal use of corporate property).

122. These requirements, such as board meetings and minutes, continue to be important for the LLEs' owners and possibly for the state agency charged with administering the LLE statutes, but should not be relevant to the question of waiving limited liability.

123. *See supra* Part II.B.2.

124. Indeed, the Minnesota Limited Liability Partnership and the Colorado, Minnesota, and Texas Limited Liability Company statutes all expressly allow "piercing" law developed for corporation to be applied equally to new LLE forms. *See* Minn. Stat. § 323.14 subd. 3(b) (West 1998) ("The use of informal procedures or arrangements for managing the limited liability partnership or conducting its

III. FAILURE OF EXISTING PIERCING TESTS

To develop a test for determining when the owner of an LLE will lose the benefit of limited liability, the place to start should be with the courts' experiences over the years dealing with this issue in the corporate context. The failure of courts' previous attempts to articulate a single test for disregarding the corporate form and holding the owners of a corporation responsible for the business's financial responsibilities has resulted in a number of overlapping lists of factors that are passed off as tests.[126] The relevance of these factors to the issue of holding an owner personally liable for a corporation's financial responsibilities is questionable and at times completely unexplored.[127] Some courts have taken to

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business is not a ground for piercing the veil of the limited liability partnership."); Colo. Rev. Stat. Ann. § 7-80-107(1) (West Supp. 1998) (noting that "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"); Minn. Stat. Ann. § 322B.303 subd. 2 (West 1998) (finding that "case law that states the conditions and circumstances under which the corporate veil of a corporation may be pierced under Minnesota law also applies to limited liability companies"); Tex. Rev. Civ. Stat. Ann. art. 1528n (West 1997) (incorporating corporate veil-piercing requirements in actual fraud cases).

125. *See* Gallinger v. North Star Hosp. Mut. Assurance, Ltd., 64 F.3d 422, 427–28 (8th Cir. 1995) (applying corporate veil-piercing test to LLC without comment); Middlemist v. BDO Seidman, LLP, 958 P.2d 486, 491 (Colo. Ct. App. 1997) (relying on Colo. Rev. Stat. § 7-60-153(1) (1997) to rule that party seeking to hold partner in LLP personally liable "must proceed as if attempting to pierce the corporate veil"); Hollowell v. Orleans Reg'l Hosp., No. Civ. A. 95-4029, 1998 WL 283298 (E.D. La. May 29, 1998) (ruling that, with exception of lowered formalities requirement, Louisiana "piercing" law developed for corporations would be applied to LLCs as well); Abu-Nassar v. Elders Futures, Inc., No. 88 Civ. 7906 (PKL), 1991 WL 45062, at *10–14 (S.D.N.Y. Mar. 28, 1991) (using corporate veil-piercing test but refusing to consider formalities, observance of which was irrelevant to any alleged harm).

126. *See* Richard v. Bell Atlantic Corp., 946 F. Supp. 54, 61 (D.D.C. 1996) (setting out four different tests: "(1) the 'agency' test under which the plaintiffs must establish that the parent exercised a significant degree of control over the subsidiary's decisionmaking; (2) the 'alter ego' test which is founded in equity and permits the court to pierce the corporate veil when the court must prevent fraud, illegality or injustice, or when recognition of the corporate entity would defeat public policy or shield someone from liability from a crime; (3) the 'instrumentality' test under which the plaintiff must establish that the parent exercises extensive control over the acts of the subsidiary giving rise to the claim of wrongdoing; and (4) the 'integrated enterprise' test under which the court considers (a) interrelations of operations, (b) centralized control of labor relations, (c) common management, and (d) common ownership or financial control."). Note that each of these tests has multiple incarnations and consists of additional lists of nonmandatory factors for the courts to consider based on the facts of each case.

127. *See, e.g.*, Laya v. Erin Homes, Inc., 352 S.E.2d 93, 98–99 (W. Va. 1986) (listing 19 factors); Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 512 (Minn. 1979). The *Victoria Elevator* court listed, without ever analyzing, eight factors:

listing all the "list tests" in their opinions before doggedly attempting to synthesize them for the case at hand.[128]

While the factors used on particular occasions by particular courts vary slightly from test to test, the factors for each test fall into three categories: procedural issues, capitalization issues, and equity issues. The factors in the first category are irrelevant and the factors in the second category are directly contrary to both efficient business practices and the purpose for limited liability. Decisions grounded on the third category, while initially more appealing, often operate at cross-purposes with the LLE statutes themselves and undermine the certainty necessary for the promotion of business.

A. Failure to Abide by Statutory Procedural Requirements

Corporations have a very definite legal structure: shareholders own the business, the board of directors makes business policy, and the officers and other employees carry out the day-to-day operations. With these discrete corporate organs and a presumptive separation of powers come certain formalities for action. Shareholders and directors typically are required by statute to take action by some form of majority vote at meetings held pursuant to notice requirements and at which a quorum of participants must be present. These statutory formalities protect participants within the corporate enterprise from surprise decisions or action without consultation. Unfortunately, claims alleging failure to abide by the formalities of a corporate statute predominate plaintiffs' attempts to hold owners personally liable for the obligations of the corporate enterprise.[129] While these requirements certainly win the

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> [I]nsufficient capitalization for purposes of corporate undertaking, failure to observe corporate formalities, nonpayment of dividends, insolvency of debtor corporation at time of transaction in question, siphoning of funds by dominant shareholder, nonfunctioning of other officers and directors, absence of corporate records, and existence of corporation as merely façade for individual dealings.

Id. at 512. An unspecified number of these factors, combined with an element of injustice or fundamental unfairness, would justify disregarding the LLE and holding the owners liable. *See id.*

128. *See, e.g., Richard*, 946 F. Supp. at 61–62 (examining agency, alter ego, instrumentality, and integrated enterprise formulations); White v. Winchester Land Dev. Corp., 584 S.W.2d 56, 61–62 (Ky. Ct. App. 1979) (examining instrumentality, alter ego, and equity formulations).

129. Observance of corporate formalities is a factor consistently present in piercing cases, regardless of the particular test applied by the court.

popularity contest with courts, they are rarely relevant to the plaintiffs' injuries in a given case.[130]

Although state statutes set out procedures that corporate actors are obligated to follow, the statutes themselves do not condition the continuance of the corporate entity on observance of these procedures, most of which are designed to protect shareholders from unfair treatment by the directors or fellow owners.[131] Indeed, it is strange that statutory protections for owners have evolved into an essential instrument used for stripping them of their statutory limited liability. As one commentator noted, "Unless the legislature designed the rule [requiring an annual meeting to elect directors] to protect creditors—something which does not appear to be the case with meeting formalities—there is no logical reason to treat compliance with the rule as a quid pro quo for limited liability."[132]

Courts often justify continued relevancy of corporate formalities based on a "privilege" or "quid pro quo" argument, which rests on two assumptions:

1. An LLE owner's failure to comply with statutory formalities indicates the owner's lack of respect for the separation demanded by the laws that are the basis of their limited liability, and "the formalities are themselves an excellent litmus of the extent to which the individuals involved actually view the corporation as a separate being,"[133] and

2. Owners expecting to enjoy the limited liability provided by the statute should comply with the demands of the statute.[134]

The first assumption is both false and irrelevant. One empirical study indicates that only those LLEs with the smallest groups of owners are

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130. *See Abu-Nassar*, 1991 WL 45062, at *9 ("It is not at all clear on the current record whether defendants were injured by any of the alleged violations of the Code.").

131. The one exception is the "excessive dividend rule" present in most corporate statutes. Legislatures enacted these antidividend provisions to protect creditors from excessive dividends. The courts have turned this on its head, however, ruling that the lack of dividend is justification to pierce. *See, e.g.*, *Victoria Elevator*, 283 N.W.2d at 512–13. It is not exactly clear how a corporation's failure to pay dividends became a source of personal liability for its owners, especially in light of the tax reasons for not paying dividends.

132. Gevurtz, *supra* note 115, at 870.

133. Labandie Coal Co. v. Blank, 672 F.2d 92, 97 (D.C. Cir. 1982).

134. *See id.* at 96–97.

prone to piercing.[135] In large part, this result occurs because these same LLEs are most often the businesses in which owners are most overworked, most likely to overlook formalities irrelevant to their actual operation of the business, and least able to pay an attorney to keep track of their formal statutory obligations. The failure of these owners to abide by sometimes expensive, often unproductive, formalities is not good evidence of misuse of a limited-liability statute intended to encourage business.

In addition, the second premise, that the law is justified in exacting the stiff punishment of personal liability where an owner fails to "respect" the law, is grounded on faulty logic as well. If the state believes that failure of a corporation's owners or other participants to observe all the formalities required by law represents a danger to the public at large, it should be able to proceed against the corporation or those involved and secure some form of punishment.

The situation is entirely different when a creditor seeks to attach an owner's personal assets. The failure of a corporation's owners to observe corporate formalities has no relevance to an individual creditor's claim against the owners, unless the nonobservance of formalities is causally related to the creditor's harm. Absent such a causal connection, a court's blind use of formalities is akin to holding a driver liable for an accident that occurred in broad daylight because the headlights were not in proper working condition.

If observance of certain procedural rituals was important to any substantive basis for imposing personal liability on a business owner, one would expect that observance of required formalities would be part of the piercing test not only for corporations, but also for other LLEs. Instead, just the opposite is true. The use of formalities as a factor for piercing any entity besides corporations has been rejected by both judicial decisions and statutes.[136]

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135. *See* Thompson, *supra* note 5, at 1047–66.

136. *See, e.g.*, Minn. Stat. Ann. § 323.14 subd. 3(b) (West 1999) (establishing that "[t]he use of informal procedures or arrangements for managing the limited liability partnership or conducting its business is not a ground for piercing the veil of the limited liability partnership"); Hollowell v. Orleans Reg'l Hosp., No. Civ. A. 85-4029, 1998 WL 283298 (E.D. La. May 19, 1998) (ruling that, with exception of lowered formalities requirement, Louisiana "piercing" law developed for corporations would be applied to LLCs as well); Abu-Nassar v. Elders Futures, Inc., No. 88 Civ. 7906 (PKL), 1991 WL 45062, at *10–14 (S.D.N.Y. Mar. 28, 1991) (using corporate veil-piercing test but refusing to consider formalities, observance of which was irrelevant to any alleged harm).

B. Undercapitalization

Courts often cite undercapitalization as a factor in their decision to pierce the corporate veil.[137] Depriving small business owners of their limited-liability protection because of their indebtedness runs counter to the purpose of limited liability. Several business-reality-based reasons, the corporation statutes, and the history of corporations all support discarding undercapitalization as a basis for finding personal liability.

First, holding a corporation's owner liable because the corporation incurs debt in excess of its assets fails to recognize the reality that most businesses are highly leveraged.[138] Even from the first day of operation, businesses often possess insufficient assets to pay their current debts: lease obligations, startup loans, and lines of credit from suppliers. This does not even take into consideration the liability a business could potentially incur even in its first hour of operation (if the business's first attempted delivery involved a horrible traffic accident, for example). It is difficult to see how any modern startup business could be "adequately capitalized."

Second, continuing to require a level of capitalization sufficient to cover even approximately a business's debts inevitably closes entrepreneurial markets at the same time that the legislatures are attempting to open them. If courts set minimum-capitalization requirements high enough to prevent creditors from going unpaid, the same requirements will operate as a significant bar to new entrants into the market.

Indeed, most legislatures long ago abandoned the minimum-capitalization requirements that were once a standard part of every corporation statute.[139] These statutes did not require corporations to maintain capital reserves sufficient to cover their debt obligations, but

137. *See, e.g.*, Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 512 (Minn. 1979). See also *supra* note 127 for a list of the factors used in *Victoria Elevator.*

138. The business world runs on leveraging—an emphasis on undercapitalization runs directly contrary to the well-accepted idea that a business's value is not affected by whether it finances its operations through the use of capital or debt. *See* Franco Modigliani & Merton H. Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 53 Am. Econ. Rev. 433 (1963); Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 Am. Econ. Rev. 261 (1958). Modigliani received the Nobel Prize in Economic Sciences in 1985, in part for these articles articulating the theorem that "neither the value nor the debts affect the value of the firm." *The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel* (Oct. 15, 1985) (press release).

139. These minimum-capitalization statutes were truly minimal. *See* Robert W. Hamilton, *Cases and Materials on Corporations* 204 (6th ed. 1998).

only to keep some minimal amount in relation to the amount of capital owners invested.[140] Most of these statutes have been repealed.[141] The repeal of statutory minimum-capitalization requirements for corporations, along with the absence of minimum-capitalization requirements in the modern LLE statutes, is strong evidence against inferring a minimum capitalization requirement for these statutory entities.

Finally, putting all these arguments to one side, it simply does not make business sense to put more money than necessary into the operation of a business. The greater the amount of capital invested, the smaller the return on equity, and the less successful the investment. To penalize business owners for operating with business acumen is a mistake. A better system would require some amount of retained capital or mandate some amount of business insurance. But the current system, which haphazardly imposes liability on the personal assets of corporate owners based on their desire to get the greatest return on their investment, simply makes no sense.

C. *Equitable Bases*

Equitable arguments for revoking the limited-liability protection afforded owners under corporate statutes fall into two distinct categories: (1) policy arguments that it is unfair to allow owners to avoid debts at the expense of a corporation's creditors, and (2) allegations that an owner committed fraud or disbursed the corporation's assets in a manner that was harmful to both the LLE and the creditor.

The second category, fraud or fraudulent transfers, constitutes a legitimate basis for revoking an owner's limited liability. In contrast to the open-ended, free-form use of these terms today, however, the focus must be reconstituted in a clear test that requires specific evidence of fraud or an owner's dishonest conduct in transferring the corporation's assets to himself or herself or some entity in which he or she has an interest (a conflicted exchange) for less than reasonably equivalent value.

In contrast, the first category of arguments is completely at odds with the state legislatures' purpose in enacting LLE statutes—promoting commercial activities. While more appealing than the corporate-formalities and undercapitalization arguments, the question of who will incur the loss when an LLE fails is a legislative determination. Once

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140. *See id.*

141. Only seven states retain minimum-capital requirements. *See id.*

legislatures adopted LLE statutes that provided limited liability for owners, perceived unfairness to creditors should not be either a subject of judicial discussion or the basis of a decision to waive an owner's statutory limited liability.

Janos v. Murduck[142] illustrates the need for a more clearly defined equitable inquiry. In *Janos*, a closely held corporation declared bankruptcy and liquidated its inventory prior to delivery of the plaintiffs' prepaid order.[143] The court began by reviewing the corporate structure and activities of the shareholders, holding that the corporation "did not exist separately from Norman Murduck."[144] The court based its conclusion solely on the fact that the defendant founded the company, was both the president and sole shareholder in the corporation, did a substantial part of the corporation's work, and approved the transaction in question.[145]

Turning to the question of whether the defendant unfairly used the limited-liability shield against the plaintiffs, the court ruled that the plaintiffs failed to present any evidence of intent to defraud or that the owner used the LLE to benefit in any improper way.[146] The court nonetheless ignored the defendant's unrebutted testimony as to the external sources of his insolvency,[147] ruling that an issue of fact existed as to whether the defendant used the corporate entity to deceive the plaintiffs because he failed to identify affirmatively the business as a corporation.[148] Finally, the court reasoned that a jury could find the defendant liable for the plaintiffs' injuries because the plaintiffs "paid full price *to Norman* for windows they never received [so that] Norman caused [their injuries]."[149]

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142. 672 N.E.2d 1021 (Ohio Ct. App. 1996).

143. *See id.* at 1023.

144. *Id.* at 1024–25.

145. *See id.*

146. *See id.* at 1025–26.

147. *See id.* at 1025.

148. *See id.* Note that the plaintiffs did not allege that the defendant made any personal guarantees or that they relied on him personally in any way. While an owner of an LLE who misrepresented his LLE status would necessarily be liable, and it may be possible under certain circumstances that an LLE owner could defraud a creditor by simply failing to identify its limited liability status, the *Janos* Court specifically found no fraud was present in the case.

149. *Id.* (emphasis added).

It is hard to imagine a decision more hostile to the idea of limited liability.[150] After creating and running a business under a statute that purported to limit his liability, the defendant owner was held liable because he actively participated in the business operations, never specifically told those he did business with that his personal liability was limited, and went bankrupt when his supplier's ordering policy changed.[151]

The *Janos* court ruled that the decision to disregard the corporation and hold the owner responsible for the business's debts is founded in equity.[152] Any court making an open-ended equitable inquiry would likely reach such a result because the very concept of limited liability is inherently inequitable. The idea that the Janoses, and not Murduck, should bear the loss when Murduck's business fails is contrary to the rules and mores of our society that teach that people are responsible for bearing their own misfortunes and should not pass them off on society at large. The limited-liability provisions in the statutes establishing corporations can be viewed as directly contrary to our cultural norms and the common law that grew out of them.[153]

Nonetheless, the legislatures of every state have adopted corporate statutes with limited-liability provisions. Continued emphasis on the inequity of LLEs' limited-liability status in the face of this near-universal statutory adoption is a clear demonstration of the hostility of courts and commentators to the policy decisions made by state legislatures. Such continued analysis of the fairness of protecting owners over creditors is akin to courts' continuing to rehash an issue about which legislatures have already spoken. There may be good arguments on both sides, but

150. In fact, the case already has spawned just a decision. *See* G & S Elec. v. Soha, No. 18665, 1998 WL 488785 (Ohio Ct. App. Aug. 5, 1998). The trial court granted summary judgment in favor of the plaintiff, piercing the veil, based on the "confusion" caused by defendant's signature as president of the corporation. *See id.* at *2. The appellate court, citing *Janos*, held that defendant's signature as president of Building Board Custom Homes, Inc., at most created a genuine issue of fact regarding the defendant's personal liability. *See id.* at *1–2.

151. *See Janos*, 672 N.E.2d at 1025. A good corporate lawyer in Ohio might now advise a majority shareholder of an LLE that to maintain limited liability, she or he should (1) not be involved in the business; (2) not personally approve any actions that the business takes; and (3) expressly tell all the LLE's customers that they will be left out in the cold if the LLE goes under. Needless to say, the Ohio corporate statute does not make limited liability contingent on any of these actions.

152. *See id.* at 1023.

153. *See, e.g.*, Sven-Olof Collin, *Bad Losers: An Investigation of the Morality of the Limited Liability of Shareholders in a Joint Stock Company*, 30 J. Econ. Issues 283 (1996).

the basic decision is a policy choice already decided by state legislatures and no longer open to debate. The legislatures that established the corporate and other LLE statutes weighed these policy choices in enacting the statutes, deciding that society in general would benefit more through the promotion of business opportunities than through the protection of contract parties.

Decisions like *Janos* render the limited-liability shield wholly illusory. Because limited-liability shields are unnecessary where the creditors enjoy the benefits of their bargains with an LLE, these courts are likely to abrogate the benefits of the LLE just at the time when owners need it most. All too often, a court's examination of the "equity" of a particular case, whether it acknowledges the inquiry as such or not, results in a disregard of statutory limited liability.

That is not to say that owners should never be held liable for the financial obligations of an LLE or that courts are always wrong. A new test is necessary to reflect both the policy decisions made by legislatures in enacting LLE statutes and the real possibility that owners might use the limited-liability shield for some purpose not intended by the legislature. By focusing courts' attention on the specific acts that operate to waive the limited-liability shield, a new test will encourage sound business practices, facilitate the growth of business, and aid creditors by waiving the shield when and to the extent that owners misuse the LLE.

IV. THE PROPOSED TEST: FRAUD, CONFLICTED EXCHANGES, AND INSOLVENCY DISTRIBUTIONS AS GROUNDS FOR WAIVING THE LIMITED-LIABILITY SHIELD

Under existing law, when the owner of an LLE agrees to take personal responsibility for the debts of the LLE or fails to maintain the LLE status in accordance with the statute,[154] the owner has waived limited liability to the extent of his or her personal responsibility. In these situations, the owner expressly waives limited liability. The proposed test that follows identifies when and to what extent a court should imply a waiver of limited liability. By restating the issue in terms of the owner's waiver rather than the court's factor balancing, the test more clearly identifies the owner's own wrongful actions as the source of the owner's loss of limited-liability protection.

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154. For example, an owner may personally guarantee some of the LLE's obligations or may fail to file required annual documents and have the entity involuntarily dissolved.

A court should find an owner of any LLE to have waived the owner's statutory limited-liability protection in three discrete situations. First, the owner of an LLE waives the shield *in toto* when the owner uses the LLE to commit a fraud (or personally commits a fraud to aid the LLE) involving material misrepresentations of the assets of the enterprise. In this situation, the owner is responsible for all of the LLE's debts.

In the second situation, an owner waives statutory limited liability when the owner causes the LLE to transfer assets or incur obligations to the owner or some entity in which the owner has a material interest (a conflicted exchange) for less than reasonably equivalent value.[155] An owner who engages in such transfers is automatically liable to creditors for the amount transferred or incurred in excess of a reasonably equivalent amount. Creditors proving that the conflicted exchange substantially contributed to the failure of the LLE to remain a going concern are entitled to recover the entire amount due from the personal assets of the owner without regard for the amount of the overpayment.

Finally, if the LLE distributes assets to the owner, akin to a dividend in the corporate context, in recognition of and as a return on the owner's ownership interest, and the distribution substantially contributes to the failure of the LLE to remain a going concern, creditors are entitled to recover the entire amount due from the personal assets of the owner.

While the proposed Model Statute includes some policy judgments,[156] the proposal has two more important purposes for providing a reasonable resolution of the issues addressed. The first is to encourage some uniformity in the application of the piercing doctrine across the variety of LLE forms by adopting a statutory formulation of the test. The second is to suggest a model for both academic and legislative review, debate, and potential adoption or modification. It is more important that the policy issues behind the piercing doctrine receive direct and open consideration than whether the proposed statute necessarily represents the best or most acceptable resolution of those issues.

155. *See supra* note 20 and accompanying text.

156. For example, our proposed statute limits recovery for tort claims. There is significant dispute over whether limited liability in the corporation should apply at all to tort claims. *Compare, e.g.*, Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L.J. 1879 (1991), *with* Joseph A. Grundfest, *The Limited Future of Unlimited Liability*, 102 Yale L.J. 387 (1992).

A. The Model Statute and Comments

PERSONAL LIABILITY OF LIMITED LIABILITY ENTITY OWNERS

Subdivision 1. DEFINITIONS

A. **Conflicted Exchange** means a transfer of money or other property from a Limited Liability Entity to an Owner of that Limited Liability Entity (or to any other organization in which the Owner has a material financial interest) in exchange for services, goods, or other tangible or intangible property of less than reasonably equivalent value.

B. **Creditor** is a person or organization to which the Limited Liability Entity is indebted based on a contract or other voluntary transaction between the Limited Liability Entity and the Creditor. These Creditors include, for example, employees, customers, trade creditors, and lenders. The term "Creditor" does not include tort claimants or governmental agencies seeking to impose statutory obligations.

C. **Insolvency Distribution** means a transfer of money or other property from a Limited Liability Entity to an Owner of that Limited Liability Entity (or to any other organization in which the Owner has a material financial interest), in respect of the Owner's ownership interest, that renders the Limited Liability Entity insolvent.

D. **Insolvent** when used with respect to a Limited Liability Entity means that the Limited Liability Entity is unable to pay its debts in the ordinary course of business. Claims that are unusual in nature or amount, including tort claims and claims for consequential damages, are not to be considered claims in the ordinary course of business for purposes of this Model Statute.

E. **Limited Liability Entity** means any corporation, limited liability company, limited liability partnership, limited partnership, or other form of business organization formed pursuant to an organizational statute providing full or partial limited liability for the organization's Owners.

F. **Owner** means any person or organization that, by reason of an ownership interest, is entitled to share in the profits of a Limited Liability Entity.

Subdivision 2. LIABILITY OF LIMITED LIABILITY ENTITY OWNERS

A. **Imposition of Liability.** Except as expressly provided in the organizational statute of a Limited Liability Entity or in other statutes regulating the activities and operations of a Limited Liability Entity, or by express agreement of the Owner, no Owner of a Limited Liability Entity shall be personally liable for the debts or obligations of the Limited Liability Entity, whether in tort, contract, or otherwise, unless the Limited Liability Entity is or becomes insolvent and:

1. the Owner, either directly or through representations made through the Limited Liability Entity, fraudulently misrepresents in any material aspect the assets of the Limited Liability Entity;

2. the Limited Liability Entity participates in a Conflicted Exchange; or

3. the Limited Liability Entity makes an Insolvency Distribution to the Owner.

B. **Extent of Liability.** Liability of an Owner pursuant to Subdivision 2.A.1 is unlimited as to all Creditors who relied on the misrepresentations. Liability of an Owner under Subdivision 2.A.2 is limited to the unreasonable portion of the Conflicted Exchange except that, if a Creditor or Creditors proves that the Owner, at the time of the Conflicted Exchange, knew that the Limited Liability Entity was insolvent or should have reasonably foreseen that the Conflicted Exchange would render insolvent the Limited Liability Entity, the Owner's liability to all Creditors is unlimited. Liability of an Owner under Subdivision 2.A.3 is limited to the amount of the Insolvency Distribution except that, if a Creditor or Creditors proves that the Owner, at the time of the Insolvency Distribution, knew that the Limited Liability Entity was insolvent or should have reasonably foreseen that the Insolvency Distribution would render Insolvent the Limited

Liability Entity, the Owner's liability to all Creditors is unlimited.

Subdivision 3. ELIMINATION OF COMMON-LAW PIERCING DOCTRINES

The common-law doctrines holding Owners of Limited Liability Entities personally liable for the obligations of the Limited Liability Entity, whether referred to as "piercing the corporate veil," "alter ego," "instrumentality," or otherwise, are inapplicable in this jurisdiction after the date of this Act.

Comments to the Model Statute

Scope. This Model Statute is designed to replace the case-by-case common-law analysis typically undertaken by courts under the rubric of "piercing the corporate veil." The Model Statute applies to all Limited Liability Entities irrespective of their underlying organizational statute and structure. The Model Statute complements other legislation, such as fraudulent transfer law and restrictions on corporate dividends, that invalidates certain transfers but does not expose Owners to unlimited personal liability.

The Model Statute is exclusive as to Owner liability except for two situations. First, the organizational statute for a given business organization may provide for more extensive liability. For example, the jurisdiction's limited liability partnership provisions could preclude elimination of tort liability or could preclude elimination of contract liability. In either event, or for any other liability provision expressly contained in the organizational statute of the Limited Liability Entity, the provisions of the organizational statute would control. Second, other statutes of the jurisdiction, for example, tax or environmental statutes, may expressly impose liabilities on the owners of Limited Liability Entities under defined circumstances. In that event, these other statutes control within the scope of their terms.

Exclusion of Claims. By the adoption of the various Limited Liability Entity statutes of this jurisdiction, the legislature has made the determination that Owners of Limited Liability Entities should enjoy the benefits of limited liability. The bases for waiving the limited liability of the Owner pursuant to this Model Statute relate solely to the actions of the owner in representing the extent of the

assets of the entity or in making transfers or distributions to the Owner or related entities.

Given this focus, two sets of potential claimants are left without recourse under the Model Statute. The first set of unsatisfied claimants are tort claimants or statutory liability claimants. Because the claims of tort claimants or statutory liability claimants place no reliance on the assets of the business or on the apparent validity of transfers made by the business, these claimants have no basis to compel elimination of liability for Owners of Limited Liability Entities. If the legislature wants to make a policy determination that certain tort claims, for example, product liability claims, or certain statutory claims, for example, workers' compensation claims, can be made directly against Limited Liability Entity Owners, the legislature is free to do so. Alternatively, the legislature could enact insurance requirements for some industries or bolster product safety requirements. Absent legislative action, however, the courts are not free to eliminate limited liability based on tort or private statutory claims.

The second set of unsatisfied claims relate to government enforcement of statutory liabilities. These liabilities can vary from tax claims to environmental claims to social security claims to antitrust claims. Once again, while the legislature is free to expressly provide personal liability for Owners in these contexts, absent such legislative action, the courts are not free to impose it otherwise.

Passive Owners. The Model Statute's focus is on behavior that either directly misleads creditors, involves self-dealing, or else causes the Limited Liability Entity to become insolvent. Therefore, passive Owners who do not engage in these activities or receive Insolvency Distributions are not personally liable under the statute even though more active Owners of the Limited Liability Entity might be liable.

B. Chart Showing the Statute's Operation and Burdens

CREDITOR CLAIMS	PROOF REQUIRED	EXTENT OF LIABILITY
Fraud	1. Material misrepresentation 2. Made intentionally or recklessly 3. Upon which plaintiff relied	Plaintiff's entire loss (but no consequential damages)
Conflicted Exchange (1)	1. Transfer of LLE assets 2. To owner (or entity in which owner has material financial interest) 3. For less than reasonably equivalent value	Unreasonable amount of the transfer
Conflicted Exchange (2)	Items 1–3 under Conflicted Exchange (1) plus that Owner knew or should have reasonably foreseen that the Conflicted Exchange would render the LLE Insolvent	All Creditors' losses (but no consequential damages)
Insolvency Distribution (1)	1. Distribution of LLE assets 2. To owner (or entity in which owner has material financial interest) 3. That renders the LLE insolvent	Amount of Distribution
Insolvency Distribution (2)	Items 1–3 under Insolvency Distribution (1) plus that Owner knew or should have reasonably foreseen that the Conflicted Exchange would render the LLE Insolvent	All Creditors' losses (but no consequential damages)

C. Applying the Test to Common Circumstances

1. Fraud

Fraud serves as an important basis for imposing unlimited personal liability. Fraud involves an intentional misrepresentation of a material fact upon which someone relies in taking some action or refraining from taking some action. If the owners of the LLE misrepresent the assets

available for the operation of the business and the payment of its debts, then creditors cannot make rational business decisions on whether to deal with the LLE. Misrepresenting the existence or value of assets on company financial statements may be the most usual behavior of this type.

Victoria Elevator Co. v. Meriden Grain Co.[157] provides a typical example of fraud in which the Model Statute would impose personal liability on the owner for the debts of the business. In *Victoria Elevator*, an owner operated a business as a sole proprietorship and then took on two partners and incorporated.[158] The consideration for the issuance to him of the corporation's shares was to be the transfer of land, equipment, and other assets to the corporation. No transfers ever took place even though he listed the properties as assets on financial statements reviewed by creditors.[159] Although the Court relied on other factors to pierce the corporate veil,[160] it would not have had to under the Model Statute. Use of the Model Statute in this type of case would clarify the basis of liability.

2. *Conflicted Exchanges*

Beyond direct fraud, creditors of businesses should be able to rely on the fact that owners of the LLE are operating it in a legitimate manner: that the owners did not transfer or cause the transfer of LLE assets without receiving reasonably equivalent value in return.[161] As long as the LLE either retains its assets or receives reasonably equivalent value in return, the LLE is whole, and the creditors' claims should be limited to the assets of the LLE.

The owner will violate the Model Statute, however, if the owner personally engages in an exchange transaction with the LLE, or transfers assets among various entities in which the owner has an interest, without returning reasonably equivalent value to the transferring LLE. Legislatures did not enact the LLE statutes to protect the recipients of an

157. 283 N.W.2d 509 (Minn. 1979).

158. *See id.* at 510–11.

159. *See id.*

160. *See id.* at 512–13. The court employed a list of eight factors, including failure to observe corporate formalities and nonfunctioning of other officers or directors. See *supra* note 127 for a list of these factors.

161. State fraudulent transfer or conveyance law, or federal bankruptcy law, may void these transfers, but these statutes do not address the personal liability of the entity's owners.

LLE's gifts, thus the creditors should be able to reach these assets. If no value was received, then the plaintiff/creditor is entitled to reach the owners themselves (or those related LLEs), who received the benefit of this "unjust enrichment." A plaintiff must have evidence of a transfer of assets between the owner and the LLE. Under the proposed Model Statute, absent fraud, this would be the essential inquiry. The court would want to know where the LLE's assets went, who controlled these entities, and what they received in return.

The proposed test applies to unreasonable asset transfers both to owners themselves and to owner-controlled entities. Single ownership groups often create multiple tiered LLEs so as to insulate the operations of a business from the resulting income. As the operating LLE is the only LLE likely to incur liabilities, the owners keep the accumulated income secure from any creditors by removing it to the "holding" entity.

Just as they may in the case of an owner who is alleged to have received the assets personally, plaintiffs may recover from other entities in which a conflicted owner has an interest, on the ground that reasonably equivalent value was not returned to the transferring LLE. The defendant LLE can respond by presenting evidence of the goods and or services it exchanged for the assets in question.

In *Dania Jai-Alai Palace, Inc. v. Sykes*,[162] an employee of a corporation formed solely to operate the parking lot of an entertainment and gambling facility injured a woman.[163] The Florida Supreme Court refused to pierce the parent and sister corporations on the grounds that the appellee demonstrated no affirmative evidence of fraud and that the appellant was put on constructive notice that different LLEs operated the Jai-Alai fronton and the parking lot in which she was injured.[164]

Under the Model Statute, there would have been no liability of the owner under the fraud branch of liability. The Court would have inquired, however, where the parking lot company's assets went and whether value was received in return. For example, if the parking lot company transferred its receipts and other assets to the sibling entity for no equivalent value, the sibling entity would be liable. In addition, it should be noted that, although the plaintiff's claim in *Dania* was stated in tort, it arose out of a contractual relationship with the LLE. Under the

162. 450 So. 2d 1114 (Fla. 1984).

163. *See id.* at 1116.

164. *See id.* at 1115–22.

Model Statute, a court should recognize this claim even though straight tort claims would not be recognizable.

3. *Insolvency Distributions*

Not all distributions to owners, however, should be suspect. Corporate distributions to shareholders, by their very nature, do not involve an exchange of value. Businesses are started to make money. Penalizing an LLE owner merely because the LLE provides a return to the owner ignores this basic fact of business.

Legitimate liability arises, however, when the LLE owner receives distributions that cause the LLE to become insolvent. This liability arises because both the creditors of a business and the statute that created the LLE presume that the LLE will be run according to two basic rules of business: that the owners intend the business to be ongoing and the assets of the business will not be distributed to owners unless there are sufficient profits also to satisfy expected debts or claims against the corporation. At the same time, businesses seldom fail for a single reason. Indeed, legitimate owners would not continue to pay themselves unreasonably when their business was suffering.

4. *Extent of the Waiver*

In light of the fact that an owner is entitled to reasonable compensation for ongoing contributions to the business and is entitled to reasonable distributions of profits, an LLE owner's liability should be presumptively limited to that amount of compensation in excess of the reasonably equivalent value of the contribution or the amount of the distribution. A creditor can overcome this presumption and demand full compensation for loss by demonstrating that the LLE would still be a going concern but for the unreasonable compensation or distributions to the owner.

In *Klokke Corp. v. Classic Exposition, Inc.*,[165] a debt-ridden corporation sold a substantial amount of its assets for over $1.2 million.[166] The corporation paid additional sums directly to the two shareholders, one of whom ran the business while the other was a

165. 912 P.2d 929 (Or. Ct. App. 1996).

166. *See id.* at 931.

completely passive investor.[167] After paying off their immediate debts, the two shareholders withdrew the remainder of the assets from the corporation, a substantial amount of which went to pay personal income taxes and a personal note.[168] The owners later designated these payments as salaries, even though one of the owners was never an employee of the corporation.[169]

The corporation soon defaulted on the leased space for its remaining operations.[170] The court found that the payment to the non-employee owner

> had nothing to do with any services that he performed or money that he loaned.... That might have been unobjectionable for a partnership, in which the partners retained their unlimited personal liability; it is, however, inconsistent with maintaining the limited liability that is part of the corporate form.
>
> . . .
>
> ... [I]t [is] clear that the withdrawal was improper and that it was a direct cause of [the LLE's] default.[171]

In determining the non-employee owner's amount of liability, however, the court relied on extensive accounting evidence showing that the other owner dominated the LLE's business affairs and that several of his business decisions contributed to the collapse of the business.[172] Because the court found that the non-employee owner's withdrawal had not caused the business to fail, the court limited the non-employee's liability to the total amount of the payment for which he gave no reasonably equivalent value.[173]

Courts applying the Model Statute test would reach the same result, but with a clearer analysis that would both promote uniform results and provide clear direction for other LLE owners. The plaintiff creditors would present evidence of the payments made to the owners, the owners

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167. *See id.*

168. The note merely represented a promise to pay the remaining amount of his "share" of the $1.2 million—the owner made no actual contribution in exchange for the note. *See id.* at 931–32.

169. *See id.* at 931 n.2.

170. *See id.* at 932.

171. *Id.* at 933–34.

172. *See id.* at 934–35.

173. *See id.*

would present evidence that the amount of the payments was a reasonably equivalent value for the owner's contributions to the LLE. Should the owner fail to carry this burden, as did the owner in *Klokke*, then the owner is liable up to the unreasonable amount paid. Should the plaintiff also prove that the LLE would still be a going concern but for the overpayments (as the plaintiffs failed to do in *Klokke*), then the owner would be liable for the plaintiff creditor's entire loss. Owners involved in neither of the challenged transactions could avoid unlimited personal liability, as did the passive owner in *Klokke*; however, such an owner would still be liable for receiving distributions that contributed to the LLE's inability to pay its debts in the ordinary course of business.

In *Dwyer v. ING Investment Co.*,[174] the court found that the LLE would have been a going concern but for certain transfers and held the owner liable without limitation for the creditor's claims.[175] In *Dwyer*, ING, which operated a clothing-manufacturing business, agreed to make installment lease payments for clothing-manufacturing equipment, rented manufacturing space, hired workers, and purchased supplies.[176] The owners of ING then formed a separate entity, Starline, for whom ING agreed to manufacture clothing in return for only the bare cost of ING's labor.[177] When ING defaulted on its debts, ING's creditors brought suit seeking to hold the partners liable for those debts.[178] The court found:

> ING lost its share of the profits from the sale of the garments produced and to be produced under the agreement in order that it could supply garments to Starline at a loss. No corporation acting in its own best interests would enter into such suicidal arrangements. The only reasonable inference is that it was being used solely to benefit the controlling entity or individual and had no will, life or existence of its own.[179]

This case reflects the general principle that creditors of an LLE are entitled to assume that the LLE will be run as a business for benefit of the business and for the normal benefit of its owners. When the owners plunder the assets of the LLE so as to bring about its demise, they may

174. 889 S.W.2d 902 (Mo. Ct. App. 1994).

175. *See id.* at 903.

176. *See id.*

177. *See id.* The partnership also used ING space for free. *See id.*

178. *See id.* at 904.

179. *Id.* at 905.

not rely on the LLE statutes to limit either the existence of personal liability or its amount. In extreme situations such as that found by the court in *Dwyer*, the court is justified in waiving the statutory limited liability *in toto*, and allowing the creditors to pursue the assets of any owners or interested entities that received the plundered LLE's assets for less than reasonably equivalent value.

V. CONCLUSION

The development of multiple statutory forms of limited liability entities, while created mainly to minimize tax burdens and to provide investors with insulation from personal liability, has provided an opportunity to clarify the bases for imposing personal liability on owners for the LLE debts. These new LLE forms also dispel any notion that limited liability for LLE owners is linked either to owner passivity or satisfaction of operational formalities. The proposed Model Statute ties liability to responsibility by imposing personal liability on business owners when their actions justify such liability. The use of the new tests under the Model Statute will give honest business owners security in knowing that their personal assets are not at risk, while preventing fraudulent owners from hiding behind the shield of limited liability.