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## A Call for a Unified Business Organization Law

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# A Call for a Unified Business Organization Law

John H. Matheson\* and Brent A. Olson\*\*

*The authors propose a wholesale reformation of business organization law. The current regime of business organization law reflects an attempt to blend the benefits of limited liability with conduit or flow-through taxation. The result has been a haphazard development of business forms, often created to satisfy shifting federal tax law guidelines. The authors trace this development, from the traditional corporation and partnership forms through limited partnerships and Subchapter S corporations to the recent organizational forms of limited liability companies and limited liability partnerships. The authors show how the search for the ideal organizational form has failed, leaving an unwieldy morass of choice of entity issues for the business owner.*

*The authors propose a two-tier framework to overhaul existing business organization law and classification. Traditional corporations would continue in existence. The remaining myriad of business forms would be replaced by a simplified Standard Business Organization ("SBO") governed by a Standard Business Code ("SBC"). The hallmarks of the SBO under the SBC would be limited liability for owners, pass-through taxation, free transferability of interests, perpetual existence or continuity of life, and presumed owner management. These attributes conform to the default features most desired by business owners.*

*Consistent with recent changes by the Treasury Department and the Internal Revenue Service in the traditional entity classification scheme for taxation purposes, the two-tier framework combines the benefits of consistency, flexibility, and simplicity. Current laws and regulations governing business organizations formed as corporations would remain intact, allowing states to continue to "race to the top" (or bottom), and affording a substantial federal entity-level tax base from these entities. The SBC would provide a flexible, owner-oriented operational structure for the SBO while avoiding entity-level taxation, except where the SBO chooses to become publicly traded. The result is a vastly simplified system of business organization law that elevates the substance of desired business organization law elements over the form of attributes necessary to satisfy federal tax guidelines.*

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[A]ll forms of business organization are essentially the same, mere variations on the same theme. . . . Entity is found with and without limited liability; there is limited liability without entity; and there are quasi-entities with and without limited liability. The constructs of business law are not immutable verities, ideal forms, but rather a rough patchwork partly the result of historical accident, partly the result of invention, and . . . partly the result of eclectic combination of forms. And each of the fifty states has its own patches on the patches.<sup>1</sup>

### *Introduction*

The ever-expanding law governing the formation and operation of business organizations encompasses everything from sole proprietorships to large publicly traded corporations.<sup>2</sup> Amid these extremes resides a seemingly endless variety of business forms and combinations of forms, including, among others, general partnerships, limited partnerships, limited liability partnerships, master limited partnerships, limited liability companies, joint stock companies, business trusts, and "partnership associations."<sup>3</sup> The existing myriad of laws and regulations governing business organizations results in an

<sup>1</sup> Robert A. Kessler, *With Limited Liability for All: Why Not a Partnership Corporation?*, 36 *FORDHAM L. REV.* 235, 252 (1967).

<sup>2</sup> For a definition of publicly traded corporations, see JOHN H. MATHESON, *PUBLICLY TRADED CORPORATIONS: GOVERNANCE, OPERATION AND REGULATION* § 1:02 (1994).

<sup>3</sup> Some business organizations address narrow, particular types of businesses (such as professional associations and not-for-profit organizations) and will not be considered further.

increasingly vast and disjointed realm so cumbersome and abstruse as to confound all but the most die-hard business law scholars and practitioners.

Many states boast over a half dozen separate statutes and codes governing the organization and operation of business entities. States typically consider each organizational entity as wholly self-contained; each statute provides a comprehensive set of legal default rules for a distinct business organization. Each state's enactments often have somewhat unique characteristics, multiplying the morass fifty times over. In addition, the Treasury Department ("Treasury") and the Internal Revenue Service ("Service") have codified several separate strains of tax law to address the issues unique to these distinct business organizations<sup>4</sup> and have addressed the other state-law manipulations on a case-by-case basis, thereby making business organization tax attributes as varied as the business forms that exist.<sup>5</sup>

The law of business organizations has thus become a hodge-podge of unwieldy, illogical, and even irrational legislation and decisions bristling with incoherence and inconsistencies.<sup>6</sup> Bursting at the seams, the fabric of business organizational law currently blanketing the nation has become a variegated quilt of legal passwords.

Fundamental reform of business organization law is both imperative and inevitable. Comprehensive reform, however, requires an understanding of both the underlying nature of business organizations—their fundamental basis and essential character—and the root causes of the current dysfunctional state of organizational law. At bottom, the potential power and simplicity of business organization law has been obscured and frustrated by a myopic focus on taxation issues; the Treasury and the Service have, in effect, dictated the substance of business organization law.<sup>7</sup>

In this Article, we explore the underlying nature of business organization law—a necessary precondition to devising a unified business organization framework—by probing the evolution of the limited liability/double-tax

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4 See I.R.C. §§ 701-709 (1994) (Subchapter K governing partnerships); *id.* §§ 1361-1363 (Subchapter S governing S corporations), amended by Small Business Job Protection Act of 1996 ("SBJPA of 1996"), Pub. L. No. 104-188, 110 Stat. 1755.

5 The cited variations do not even address the separate levels of state and local taxation that add to the complexity. In addition, various federal and state regulatory laws, such as securities regulation laws, have to be interpreted in the light of this complexity.

6 See William J. Rands, *Passthrough Entities and Their Unprincipled Differences Under Federal Tax Law*, 49 SMU L. REV. 15 (1995) (asserting that the tax law regarding pass-through entities should be reformed and uniform rules should be established).

7 But what if the Service was removed from the equation, or more precisely, what if the role of taxation was, at long last, simplified to the point of allowing a business entity to elect either entity-level or conduit taxation? Amazingly, in 1996, the Service in effect conceded that it is the inappropriate organ to dictate the business organization laws of the several states. See *infra* Part II.F. Specifically, the Treasury has indicated that it intends to exit the organizational law quagmire. See *infra* notes 199-210 and accompanying text. This is really quite extraordinary: the final roadblock to arriving at a coherent and logical business organization law may soon be reduced to a historical footnote. Once freed from its tax fetters, business organization law could take one of two courses: (1) an optimal, unified business organizational law could emerge, injecting much needed uniformity, simplicity, efficiency, and clarity into the current business organization wasteland; or (2) in a wild frenzy, legislators could develop still more forms of business organizations as each state caters to its various constituencies.

dilemma. Part I of this Article sets forth a brief history of the law governing business organizations, highlighting the twin strands of taxation and limited liability that form the double helix from which all business organizations derive. Part II analyzes the role of taxation in the organizational form and the failure of the efforts to deal with the liability/tax issue.

We then argue that business organization law should consist of a simple two-tier business organizational structure. Part III sets forth our proposal for simplifying business tax law and for unifying business organization law by introducing a structured, all-encompassing framework that lays the groundwork for model business organization legislation. Part IV analyzes and investigates the impact of our proposal upon the current business law terrain.

We reform business organization law by dismantling the current regime in favor of a simple two-tier statutory framework. One statute retains the traditional corporate code ("TCC") in which the business organization is formed as a corporation and is taxed as a separate entity. This entity is sometimes referred to as a C corporation. We term it the traditional corporate organization ("TCO"). Any organization wishing to be governed by this relatively clear and rigid model must confront double taxation. The second tier exploits our unification principle by distilling the myriad of non-TCC business organization statutes into one simplified statute, the Standard Business Code ("SBC"). We refer to the resulting simplified entity as the Standard Business Organization ("SBO"). This SBC replaces all business organization statutes other than the TCC.<sup>8</sup>

The current maze of organizational statutes and tax rules cries for a unification principle that would enable every jurisdiction to adopt a uniform statute and allow the Treasury and the Service to issue uniform regulations as to a *single* business entity. Granted, this is no simple task; as yet no such proposal exists.<sup>9</sup> This Article fills this void by proposing a model framework for unifying business organization law.

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<sup>8</sup> To be sure, no business would have to organize and file under either the TCC or the SBC. Those businesses not so electing would be governed by the common law of agency, sole proprietorship, and partnership. It is expected, however, that such organizations would be relatively few, as the advantages of limited liability that flow from formation under either the TCC or the SBC would be inviting for any organization other than those informally organized without counsel.

<sup>9</sup> There have been a handful of attempts, however. For example, three states—New Jersey, Michigan, and Ohio—developed legislation creating a "limited partnership association." Pennsylvania also had this cumbersome statute until 1965 when it was repealed. See generally Edward R. Schwartz, *The Limited Partnership Association—An Alternative to the Corporation for the Small Business with "Control" Problems?*, 20 RUTGERS L. REV. 29 (1965) (propounding the use of the limited partnership association form for small, localized enterprises). Looking back several decades, two scholars have considered the possibility of a single small business structure. See Harry J. Haynsworth, *The Need for a Unified Small Business Legal Structure*, 33 BUS. LAW. 849, 867 (1977) (suggesting "an unsophisticated, vastly over-simplified" framework to "stimulat[e] further thought and debate"); Kessler, *supra* note 1, at 277-306 (proposing model statute for a partnership-corporation).

## I. *Confronting the Limited Liability/Double-Tax Dilemma: The Evolution of Business Organization Law*

### A. *Limited Liability as the Linchpin of Business Organization Law and Modern Capital Accumulation*

The recognition of the existence of an incorporate person necessarily involves the recognition of the three following principles: (i) A corporation is a person distinct from its members; (ii) the property of the corporation is distinct from the property of its members; (iii) the property of its members cannot be taken in execution for the debt of the corporation, and vice versa.<sup>10</sup>

The classic sole proprietorship or general partnership contemplates one or a small group of business owners that actively participate in the business.<sup>11</sup> The personal assets of sole proprietors and general partners remain unprotected and exposed to attachment by creditors.<sup>12</sup> These owners face the prospect of unlimited personal liability for the obligations of the business, except as may be limited by insurance or agreement.

Traditionally, the major advantage of doing business in the corporate form was the ability of business owners—shareholders—to limit their personal liability for the debts and obligations of the business to their actual and promised contributions. Business creditors must look to the corporate assets for satisfaction of claims. Creditors generally cannot proceed against the shareholders' personal assets because they are shielded from loss by the corporate entity.<sup>13</sup>

Over time, more closely held businesses that might have been operated as sole proprietorships or general partnerships began to incorporate, often in

<sup>10</sup> 3 WILLIAM HOLDSWORTH, *A HISTORY OF ENGLISH LAW* 482 (1942) (emphasis omitted).

<sup>11</sup> 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 the partnership, bear joint and several liability for partnership obligations, share profits and losses equally, have equal rights to manage the 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).

<sup>12</sup> See REVISED UNIF. PARTNERSHIP ACT §§ 306-308, 6 U.L.A. 45, 46-47, 49-50; UNIF. PARTNERSHIP ACT §§ 15-16, 6 U.L.A. 456, 501.

<sup>13</sup> See, e.g., REVISED MODEL BUS. CORP. ACT § 6.22(b) (1984) (amended 1996) (stating "[u]nless 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 a limited partnership only the general partners are personally liable for debts to third parties). Using principles developed under the common law, creditors might proceed against personal shareholder assets if a court could be convinced to "pierce the corporate veil." See LEWIS D. SOLOMON & ALAN R. PALMITER, *CORPORATIONS: EXAMPLES AND EXPLANATIONS* §§ 6.1-28 (2d ed. 1994) (discussing how creditors often seek to have the court disregard the corporate form and impose unlimited personal liability on shareholders and managers). Additionally, legislative enactments, such as environmental liability laws, sometimes impose liability directly on the owners. See, e.g., Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), 42 U.S.C. §§ 107(a)(1), 9601(35), 9607(a)(1) (1994) (making an owner of a facility where hazardous substance is found responsible for clean up); Lynda J. Oswald, *Strict Liability of Individuals Under CERCLA: A Normative Analysis*, 20 B.C. ENVTL. AFF. L. REV. 579 (1993).

order to obtain limited liability protection.<sup>14</sup> Limited liability thus represents the primary distinguishing feature between a corporation and a sole proprietorship and general partnership. 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.

### 1. *The Legal Development of Corporate Limited Liability*

American law governing corporate limited liability has a contentious history. In the 1800s, Thomas Cooper described limited 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."<sup>15</sup> 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."<sup>16</sup>

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 enjoy the benefits of limited liability.<sup>17</sup> Prior to that time, incorporation typically required a special act of Parliament or a state legislature.<sup>18</sup> State legislatures enacting general corporation statutes usually imposed substantial limitations on corporations, including minimum paid-in capital requirements, limited permissible purposes, and limited duration.<sup>19</sup> 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.<sup>20</sup>

State legislatures grant limited liability to owners of corporations to better facilitate business formation within that state. Just as Jacksonian liberals argued in the 1800s that a state's failure to grant limited liability to corporate owners would drive capital to other states,<sup>21</sup> legislatures today enact various modern liability-protective business codes, such as the currently popular lim-

<sup>14</sup> 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").

<sup>15</sup> THOMAS COOPER, LECTURES ON THE ELEMENTS OF POLITICAL ECONOMY 247, 250 (2d ed. 1830), quoted in HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937 50 (1991) (internal quotation marks and footnote omitted).

<sup>16</sup> MAURICE WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 2-3 (1927), quoted in STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL § 1.01, at 1-5 (1996).

<sup>17</sup> 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.").

<sup>18</sup> See HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 12, at 24-25 (3d ed. 1983).

<sup>19</sup> See *id.* at 25-26.

<sup>20</sup> See *id.* at 26-32.

<sup>21</sup> See Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover*

ited liability company legislation, fearing that, without such enactment, economic opportunities would shift to competing states.

So fundamental is limited liability to the basic objectives of the business owner that, in 1980, the Treasury proposed regulations elevating limited liability to the dispositive factor in determining entity classification,<sup>22</sup> providing that "the term 'partnership' can apply only to an organization some member of which is personally liable under applicable local law for debts of the organization."<sup>23</sup> The Treasury withdrew its proposed regulations in 1982 while contemporaneously announcing the beginning of a study project to review whether partnership taxation should be applied to entities in which no owner is personally liable.<sup>24</sup> The study concluded in 1988 with the issuance of the Wyoming limited liability company revenue ruling,<sup>25</sup> in which the Service ruled that limited liability was simply one of four factors used to determine entity classification and was no more or less important than any of the other three factors.<sup>26</sup> The Service concluded that a Wyoming limited liability company<sup>27</sup> could be classified as a partnership for tax purposes even though no owner was liable<sup>28</sup> for any of the entity's debts.<sup>29</sup>

## 2. Capital Accumulation and the Evolution of Corporate Law

Following the Industrial Revolution, capital-intensive business required substantial capital expenditures beyond the means of the typical shareholder/employee, requiring the infusion of outside investment.<sup>30</sup> Granting limited liability to those who contributed capital encouraged investment, because investors could invest without risking their full net worth. 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 enables venture capitalists to invest in diverse enterprises without incurring the excessive costs necessary to monitor each enterprise closely.<sup>31</sup>

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*Statutes*, 61 *FORDHAM L. REV.* 843, 843-47 (1993) (summarizing the literature and the debate regarding the competition among states for corporate business).

<sup>22</sup> See Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,709 (1980).

<sup>23</sup> See *id.*

<sup>24</sup> See I.R.S. News Release IR-82-145 (Dec. 16, 1982); see also Louis F. Lobenhofer, *Limited Liability Entities in Ohio: A Primer on the Limited Liability Company and Partnership with Limited Liability, Their Substantive and Tax Aspects*, 21 *OHIO N.U. L. REV.* 39 (1994).

<sup>25</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360.

<sup>26</sup> See *id.* at 361 (instructing that "equal weight must be given to each of the four corporate characteristics of continuity of life, centralization of management, limited liability and free transferability of interests").

<sup>27</sup> See WYO. STAT. ANN. §§ 17-15-101 to -144 (Michie 1989 & Supp. 1996).

<sup>28</sup> See *id.*

<sup>29</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360, 360-61. The entity lacked continuity of life and free transferability of interest, two factors that suggest classification of a business entity as a corporation for tax purposes. See *id.*; see also *infra* Part III.B.2 (noting that whether a corporation is private or publicly traded is an important tax consideration).

<sup>30</sup> See generally HOVENKAMP, *supra* note 15, at 49-55 (describing a postindustrial era shift toward limited liability for shareholders calculated to facilitate infusion of capital into new businesses).

<sup>31</sup> See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF*



Limited liability enables owners to allocate risks and shift losses.<sup>32</sup> If a creditor suffers a loss—including a loss occasioned by a corporation's tortious conduct—the creditor has little practical recourse against an insolvent corporation.

Some commentators suggest that less justification exists for granting limited liability to owners in closely held businesses.<sup>33</sup> The primary justification for limited liability of owners is that limited liability facilitates capital accumulation when ownership and management are separate.<sup>34</sup> Ownership and management are nearly identical in most close corporations and such owners/managers are more likely to invest, without the benefit of limited liability, when they participate in control. Courts, perhaps recognizing the lesser justification for protection of shareholders of closely held corporations from personal liability, apply the doctrine of piercing the corporate veil almost exclusively to closely held corporations.<sup>35</sup>

Corporate law, while securing limited liability, provides that corporate power must be exercised according to certain mandatory rules, which "govern defined issues in a manner that cannot be varied by corporate actors."<sup>36</sup> For example, all corporations presumptively must have a central governance group embodying the board of directors.<sup>37</sup> Corporate law requires share-

CORPORATE LAW 41-42 (1991) (reasoning that limited liability encourages investor diversification and discourages close monitoring of each individual investment).

<sup>32</sup> See HOVENKAMP, *supra* note 15, at 53 (noting that the risk of liability is allocated among investors, limited to the amount of each investor's capital input, and that limited liability shifts a portion of the risk of loss to creditors).

<sup>33</sup> See, e.g., Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 148 (1980) (arguing that "a limited liability regime will, in many cases, create incentives for owners to exploit a moral hazard and transfer uncompensated business risks to creditors, thus inducing costly attempts by creditors to reduce these risks"); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Liability for Corporate Torts*, 100 YALE L.J. 1879, 1882 (1991) (relating that "[t]he most familiar inefficiency created by limited liability is the incentive it provides for the shareholder to direct the [closely held] corporation to spend too little on precautions to avoid accidents").

<sup>34</sup> See Halpern, *supra* note 33, at 125 (discussing financial literature theorizing that an unlimited liability scheme encourages owners to monitor management's actions, thereby increasing corporate transaction costs and decreasing the attractiveness of the investment).

<sup>35</sup> See 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, *CLOSE CORPORATIONS* § 1.10, at 1-46 (3d ed. 1994) (describing an empirical study revealing that virtually all instances in which courts pierced the corporate veil involved close corporations). A corporation is regarded as a legal entity independent of its owners. See *id.* "Piercing the corporate veil" is a judicial doctrine which allows a court to disregard the separate corporate entity and hold owners liable for the debts of the corporation. See *id.* Courts often opine that the corporate veil will be pierced only in unusual circumstances: "whenever the separateness of the corporate form is employed to evade an existing obligation, circumvent a statute, perpetuate fraud or crime or generally commit an injustice or gain an unfair advantage." *Id.* § 1.10, at 1-47. While courts apparently do not pierce the corporate veil to shareholders of publicly held corporations, an empirical study disclosed that the corporate veil was pierced in 40% of reported cases involving closely held corporations. See *id.*

<sup>36</sup> Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1461 (1989) (internal footnote omitted).

<sup>37</sup> See DEL. CODE ANN. tit. 8, § 141(a) (1991) (board of directors required unless otherwise provided in certificate of incorporation); REVISED MODEL BUS. CORP. ACT § 8.01 (1984) (amended 1996) (board of directors required unless all shareholders agree to a nontraditional form of governance); *id.* § 8.03 (number and election of directors).

holders to elect the board of directors through regularly scheduled annual elections<sup>38</sup> or special elections.<sup>39</sup> In order to provide some accountability, perpetual directorships are often banned<sup>40</sup> and fiduciary duties of directors and management are mandatory.<sup>41</sup>

Professor Bernard Black suggests that these and other mandatory aspects of corporate law are, for the most part, “trivial,”<sup>42</sup> arguing that investors and managers can (with the requisite legal assistance)<sup>43</sup> “establish[ ] any set of governance rules they want.”<sup>44</sup> Therefore, “the mandatory/enabling balance . . . isn’t really there.”<sup>45</sup> Corporate law may be entirely enabling to the extent that many mandatory rules “are either avoidable or have no bite.”<sup>46</sup> In any event, corporate law also provides “suppletory rules” to facilitate the joining of relatively passive investors with active managers.<sup>47</sup>

In any event, current corporate codes do provide for limited liability and a structure of governance between and among the shareholders (owners) and the directors and officers (managers). The legal principle of limited liability has given investors assurance of a definite and certain investment risk.<sup>48</sup> Thus, granting limited liability to corporations advances economic policies by encouraging business activity in general.<sup>49</sup>

38 See, e.g., DEL. CODE ANN. tit. 8, § 211(b) (“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) (“A corporation shall hold a meeting of shareholders annually at a time stated in or fixed in accordance with the bylaws.”).

39 See, e.g., DEL. CODE ANN. tit. 8, § 211(d) (special meetings may be called by board or according to bylaws); REVISED MODEL BUS. CORP. ACT § 7.02 (special meetings may be called by board, by 10% of shareholder votes, or according to bylaws).

40 See EASTERBROOK & FISCHER, *supra* note 31, at 3 (noting that “[s]tates almost uniformly forbid perpetual directorships”).

41 Professor Gordon enumerates Delaware’s mandatory rules. See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1553-54 n.16 (1989). But cf. Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1599-1602, 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”).

42 See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 Nw. U. L. REV. 542, 544 (1990) (suggesting a “triviality hypothesis” where “appearances notwithstanding, state corporate law is trivial” and “what is left of state corporate law is an empty shell that has form but no content”).

43 Black suggests that instead of black-letter corporate law, “we [law professors] teach corporate law courses where the central themes include how complex organizations are structured, and how corporate law and planning by corporate lawyers can facilitate those structures.” *Id.* at 593. Accordingly, Black appears to argue that “clever lawyers” are able to go beyond the black-letter to facilitate their clients’ needs. See *id.*

44 *Id.* at 544.

45 *Id.* at 551.

46 *Id.*

47 See JAMES W. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970* 159 (1990) (arguing that “we must not exaggerate the role of corporation law in mobilizing capital for the large enterprise”).

48 The limits of limited liability are expressed primarily by the “piercing the corporate veil” doctrine. See WORMSER, *supra* note 16.

49 See Hansmann & Kraakman, *supra* note 33, at 1879 (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.

### B. Double Taxation as the Evil Non Plus Ultra

[P]olicymakers have allowed the tax tail to wag the economic dog.<sup>50</sup>

Congress is creating an increasing number of separate tax molds, each with its particular quirks, each having certain advantages and disadvantages, and each suggesting a different haven into which confused taxpayers may rush for solace.<sup>51</sup>

The underlying policy issue involved with regard to entity classification centers on whether business entities should be treated as separate legal persons and taxed as separate entities or should be permitted pass-through treatment. Another issue is whether taxation should otherwise be "integrated" such that income will be taxed at only one level. Policymakers must decide which businesses are to be subject to separate—or double—taxation in addition to the taxation of their owners.

Classifying an entity for tax purposes as either a partnership or a corporation is of central importance to choice-of-entity concerns: generally corporations are subject to entity-level taxation while partnerships are entitled to pass-through treatment.<sup>52</sup> Since its inception, the Internal Revenue Code ("Code") has imposed a two-tier structure of taxation on corporations<sup>53</sup> while treating partnerships, even prior to the enactment of Subchapter K in 1954,<sup>54</sup> as mere aggregations of their partners not separately taxable as a business entity.<sup>55</sup>

Under this treatment, partnership income is attributed to the partners and not the partnership. Thus, the partnership itself is not subject to tax.<sup>56</sup> Similarly, losses and tax credits also pass through to the partners<sup>57</sup> even in the

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").

<sup>50</sup> Daniel S. Goldberg, *The Tax Treatment of Limited Liability Companies: Law in Search of Policy*, 50 BUS. LAW. 995, 1017 (1995).

<sup>51</sup> Mortimer M. Caplin, *Income Tax Pressures on the Form of Business Organization: Is It Time For a "Doing Business" Tax?*, 47 VA. L. REV. 249, 249 (1961) (Mr. Caplin was a former Commissioner of the Service).

<sup>52</sup> See ROBERT W. HAMILTON, *FUNDAMENTALS OF MODERN BUSINESS* 294 (1989).

<sup>53</sup> See BORIS I. BITTKER & JAMES S. EUSTICE, *THE FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.01, at 1-2 to -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 the development of the corporate tax culture and proposing a reform package); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 53-55 (1990) (discussing the development and significance of the corporate excise tax).

<sup>54</sup> See Act of Aug. 16, 1954, ch. 736, 68A Stat. 250 (revising the internal revenue laws of the United States).

<sup>55</sup> See HAMILTON, *supra* note 52, at 294 ("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 the entity versus the aggregate approach to partnership taxation).

<sup>56</sup> See I.R.C. § 701 (1994).

<sup>57</sup> See *id.* § 702.

absence of partnership income or tax on that income.<sup>58</sup> In contrast, a corporation, other than one electing S corporation status, is subject to double taxation: it is taxed once as an entity<sup>59</sup> and, generally, its shareholders are taxed on distributions of dividends which are treated as ordinary income.<sup>60</sup> Moreover, because corporate losses do not pass through to the shareholders, such losses cannot be used to offset the shareholders' other income.<sup>61</sup>

### 1. Entity Level Tax: The Dreaded Double Tax

The underlying problem is that Congress has failed to articulate any clear rationale for the double-tax system . . . . The unfairness and nonneutrality of the current rules produce drastic differences in taxation based on relatively minor organizational distinctions.<sup>62</sup>

The Code subjects the net profits of most corporations to a two-tier tax:<sup>63</sup> a corporation's annual net profits are taxed at the corporate level<sup>64</sup> while earnings distributed to shareholders are taxed again as ordinary income at shareholders' personal rates.<sup>65</sup> Retained earnings escape double taxation only temporarily: the profits generated by these retained earnings are taxed at the corporate level.<sup>66</sup> Moreover, these earnings are taxed again at the shareholder level either when they are distributed or when the shares are sold by a shareholder.<sup>67</sup>

Arguably, the corporate tax imposes "efficiency losses."<sup>68</sup> Some of these losses occur because the tax is effective: by lowering the return to corporate

<sup>58</sup> The limitation on the use of passive activity losses and credits under Code § 469 is applied at the partner level. *See id.* § 469, amended by SBJPA of 1996, Pub. L. No. 104-188, § 1704(d)(1), (e)(1), 110 Stat. 1755, 1878-79.

<sup>59</sup> *See id.* § 11.

<sup>60</sup> *See id.* § 61(a)(7) ("[G]ross income means all income from whatever source derived, including . . . dividends . . .").

<sup>61</sup> *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).

<sup>62</sup> Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 AM. J. TAX POL'Y 13, 47 (1995) (internal citation omitted).

<sup>63</sup> *See* I.R.C. §§ 301-381 (Subchapter C) (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 amended by SBJPA of 1996 § 1702(h)(7), 110 Stat. at 1874; *cf. id.* §§ 1361-1375 (Subchapter S) (imposing a single tax on certain closely held corporations), amended by SBJPA of 1996, Pub. L. No. 104-188, 110 Stat. 1755.

<sup>64</sup> *See id.* § 11.

<sup>65</sup> *See id.* § 1, amended by SBJPA of 1996 § 1704(m)(1), (2)(A)-(B), 110 Stat. at 1882-83; *id.* § 61(a)(7).

<sup>66</sup> *See* WARREN, JR., *supra* note 61, at 1-12.

<sup>67</sup> *See id.*

<sup>68</sup> *See id.* at 21-46 (summarizing defects of double tax); George F. Break, *Corporate Tax Integration: Radical Revisionism or Common Sense?*, in FEDERAL TAX REFORM: MYTHS AND REALITIES 55, 60-63 (Michael J. Boskin ed., 1978) ("Both present and future generations are affected in important ways by the economic distortions created by a separate corporation income tax."); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717, 721-38 (1981) (discussing the relationship between individual and corporate taxation).

capital<sup>69</sup> the corporate tax discourages investment in the corporate sector.<sup>70</sup> One commentator suggests that “[t]his may reduce efficiency by lowering output in industries that find a corporate form of organization particularly suitable.”<sup>71</sup>

Integration by way of pass-through taxation might eliminate many of the problems created by double taxation.<sup>72</sup> Even though integration has achieved the support of scholars, professional groups,<sup>73</sup> various Treasury reports,<sup>74</sup> presidential administrations,<sup>75</sup> and nu-

<sup>69</sup> No consensus exists as to who bears the ultimate burden of a corporate tax. Although initially the burden of the corporate tax falls on corporate shareholders, the tax burden may shift, in part or in whole, from corporate shareholders to others, such as labor, firm customers, or capital generally. See Thomas D. Griffith, *Integration of the Corporate and Personal Income Taxes and the ALI Proposals*, 23 SANTA CLARA L. REV. 715, 724-31 (1983) (concluding that theoretical and empirical literature favors the hypothesis that, at least in the short run, corporate shareholders bear the burden of double taxation); Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215, 215-17 (1962). Compare MARIAN KRZYZANIAK & RICHARD A. MUSGRAVE, *THE SHIFTING OF THE CORPORATION INCOME TAX: AN EMPIRICAL STUDY OF ITS SHORT-RUN EFFECT UPON THE RATE OF RETURN 1-66* (1963) (comparing theoretical corporate income tax arguments with the results of empirical study), with John K. McNulty, *Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and Individual Income Taxes, and International Aspects*, 12 INT’L TAX & BUS. LAW. 161, 257-59 (1994) (discussing controversy over who bears burden of corporate tax).

<sup>70</sup> See, e.g., DEPARTMENT OF THE TREASURY, REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 125-28 (1992) [hereinafter TREASURY REPORT]; WARREN, JR., *supra* note 61, at 22-28 (concluding that the corporate rate structure creates a disincentive to invest in new corporate stock).

<sup>71</sup> Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 329 (1995) (internal footnotes omitted) (citing WARREN, JR., *supra* note 61, at 25-28; TREASURY REPORT, *supra* note 70, at 115-16).

<sup>72</sup> See, e.g., William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 43-57, 73-74 (1972) (discussing the adverse effects of double taxation on the corporate entity and advocating pass-through taxation for corporations). Some scholars, however, defend a corporate-level tax. See Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 229-37 (1991) (defending double taxation of corporations based on “agency cost considerations”); Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1883-86 (1994) (“Cognitive theory . . . helps to explain at least the political appeal of the corporate income tax.”).

<sup>73</sup> See WILLIAM D. ANDREWS, AMERICAN LAW INST., SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND REPORTER’S STUDY ON CORPORATE DISTRIBUTIONS 356-400, 514 (1982).

<sup>74</sup> See DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 4-5, 171 (2d ed. 1984) (revised edition of 1977 *Treasury Report*) (endorsing full corporate integration whereby corporations would not be subject to tax but “shareholders would be taxable on their *pro rata* share of corporate income”); 2 DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 136-37 (1984) (proposing dividend deduction system).

<sup>75</sup> Treasury Secretary William Simon proposed corporate tax integration under the Ford Administration. See *Tax Reform: Public Hearings Before the House Comm. on Ways and Means*, 94th Cong. 3857-58 (1975) (testimony of William Simon, Secretary of the Treasury). The proposal appeared again in *Tax Reform Act of 1975: Hearings on H.R. 10612 Before the Senate Comm. on Finance*, 94th Cong. 70-77 (1976) (testimony of William Simon, Secretary of the Treasury). Both the Carter and Reagan administrations considered integration. See JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 204-05 (1985) (discussing Carter administration’s proposal of a comprehensive tax reform package for integration of individual

merous members of both houses of Congress,<sup>76</sup> the double tax persists.

Some scholars suggest that the double tax persists because the public supports it<sup>77</sup> in as much as the public views corporations as distinct entities subject to taxation like any individual.<sup>78</sup> Other commentators argue "that the corporate tax persists because it serves congressional objectives."<sup>79</sup> In any event, the focus typically has not been on elimination of the entity or double tax but rather on the determination of which business organizations will be subject to it.

## 2. *The Kintner Four-Factor Test*

Incorporated businesses are presumptively taxed as entities separate from their owners. Other forms of business organization may be taxed separately or not, depending on the organizational characteristics of the particular business. Under current Treasury Regulations, four attributes, or characteristics, distinguish businesses treated as partnerships for federal income tax purposes from businesses treated as associations taxable as corporations. These attributes, known as the *Kintner* factors,<sup>80</sup> are (i) continuity of life; (ii) centralized management; (iii) limited liability; and (iv) free transferability of

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and corporate income taxes); Norman Jonas, *That Wasn't Really a Gaffe on Corporate Taxes*, Bus. Wk., Feb. 14, 1983, at 38 (discussing the possibility of Reagan administration "sharply reducing, revising, or even abolishing" the corporate tax).

76 In 1978, Representative Al Ullman introduced legislation that would have partially integrated the corporate tax. See 124 CONG. REC. 2132-34 (1978) (proposal of Rep. Ullman representing "a start toward eliminating the double taxation of dividends"); *id.* at 7978-80 (statement of Rep. Ullman). The litany of other bills advocating integration include S. 1700, 103d Cong. (1993) (Sen. Simon); H.R. 948, 103d Cong. (1993) (Rep. Regula); H.R. 669, 103d Cong. (1993) (Rep. Dornan); S. 3102, 102d Cong. (1992) (Sen. Simon); H.R. 663, 102d Cong. (1991) (Rep. Dornan); H.R. 4707, 101st Cong. (1990) (Rep. Campbell); H.R. 4457, 101st Cong. (1990) (Rep. Vander Jagt); S. 1161, 101st Cong. (1989) (Sen. Shelby); H.R. 1052, 101st Cong. (1989) (Rep. Dornan); H.R. 3668, 100th Cong. (1987) (Rep. Dornan); H.R. 6436, 98th Cong. (1984) (Rep. Shannon); H.R. 1445, 97th Cong. (1981) (Rep. Sawyer).

77 See Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 60-61 (1990) ("While public opinion does not support a high degree of progressivity, it holds that wealthy individuals should pay their 'fair share' of tax."); see also Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 345-46 (1993) (suggesting that the connection between corporations and voters is "too attenuated" to engender opposition to the corporate income tax).

78 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").

79 Arlen & Weiss, *supra* note 71, at 332. "The most common variation on this theme is the 'hidden tax' argument: The corporate tax is a politically expedient way of raising revenue because the public does not understand that it ultimately bears the burden of the tax." *Id.* (footnote omitted).

80 See Treas. Reg. § 301.7701-2(a)(1) (1995). The regulations are known as *Kintner* regulations because they were enacted in response to a United States Court of Appeals for the Ninth Circuit decision holding that an association's tax status was determined by its corporate characteristics. See *infra* notes 86-94 and accompanying text.

interests.<sup>81</sup> In order to be classified as a partnership or a limited liability company the entity must lack at least two of these characteristics.<sup>82</sup>

This four factor test originated in *Morrissey v. Commissioner*,<sup>83</sup> 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 ruled that the trust resembled a corporation and therefore should be classified as an association taxable as a corporation.<sup>84</sup> 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.<sup>85</sup>

In *United States v. Kintner*,<sup>86</sup> 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. The United States Court of Appeals for the Ninth Circuit found for the taxpayer, holding the organization had sufficient corporate characteristics to qualify as an association taxable as a corporation and thereby able to avail itself of the benefits of corporate pension tax law.<sup>87</sup>

The Treasury responded to *Kintner* by proposing new regulations in 1959<sup>88</sup> that were modified and adopted in 1960 as final regulations.<sup>89</sup> The 1960 *Kintner* regulations, which are basically the current regulations, attempted to prevent noncorporate entities from obtaining the pension plan advantages of corporations.<sup>90</sup> The limitation particularly affected profession-

81 See Treas. Reg. § 301.7701-2(a)(1). Free transferability of interests exists if each of the owners of the organization—or those owners owning "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. See *id.* § 301.7701-2(e)(1). 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 an Oklahoma limited liability company lacked free transferability of interests because transfer required the consent of a majority of the 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). If the owner may freely transfer only economic rights, free transferability is not present. See *id.* Revenue Procedure 95-10 follows this division by stating that the Service 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. See Rev. Proc. 95-10 § 5.02(2), 1995-1 C.B. 501, 504.

82 See Treas. Reg. § 301.7701-2(a)(3).

83 296 U.S. 344, 345, 359-60 (1935).

84 See *id.* at 360.

85 See *id.* at 360-61.

86 216 F.2d 418, 418-19 (9th Cir. 1954).

87 See *id.* at 428.

88 See Prop. Treas. Reg. § 301.7701, 24 Fed. Reg. 10,450 (1959) (distinguishing partnerships from corporations).

89 T.D. 6503, 1960-2 C.B. 409-25.

90 See Victor E. Fleischer, "If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification, 96 COLUM. L. REV. 518, 526 (1996) ("The Treasury responded to *Kintner* in 1960 by promulgating new entity classification regulations . . . designed to

als who, at the time of *Kintner*, were unable to incorporate under state corporate laws.<sup>91</sup> The regulations sought to accomplish this result by shifting the regulatory bias toward partnership classification.<sup>92</sup>

Despite the importance of entity-level taxation, the four factor *Kintner* test fails to express any clear policy objective. That is, the Treasury made no attempt—other than precluding professional associations from qualifying as corporations and obtaining retirement tax benefits available only to corporations—to accomplish a coherent policy objective.<sup>93</sup> Consequently, although many ruminations and considerations intervened, the *Kintner* test remains basically the same today.<sup>94</sup> It is this four-factor corporate characteristic test that drives the formation of business entities today and fuels the adoption of new business organization laws that strive to limit liability and eliminate double taxation.

## II. Failed Efforts to Resolve the Limited Liability/Double-Tax Dilemma: Law in Search of Policy

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 polar models of the corporation and the general partnership. These hybrid entities more or less form a continuum between the pure general partnership and the pure corporation in an attempt to create the ideal form of business organization. Although we highlight only the main forms of such alternative entities, the potential variations based on combination of forms and affiliate ownership is limited only by the creativity and risk adversity of the crafter.

### A. S Corporations

Congress adopted Subchapter S to address the double-tax/limited liability dilemma by affording certain corporations partnership-like tax treatment.<sup>95</sup> Congress also believed that Subchapter S would simplify the tax law by reducing its impact on the choice of business form.<sup>96</sup> Although corporations electing taxation under Subchapter S are taxed as pass-through entities,<sup>97</sup> S corporation status restricts the number and identity of permissible

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make it more difficult to achieve association status.”); Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 *MINN. L. REV.* 603, 605 (1965) (discussing how the *Kintner* regulations foreclosed ability of professional partnerships to be treated as associations for federal tax purposes).

<sup>91</sup> See Scallen, *supra* note 90, at 605.

<sup>92</sup> See *id.*

<sup>93</sup> See Fleischer, *supra* note 90, at 526.

<sup>94</sup> See Prop. Treas. Reg. § 301.7701, 24 Fed. Reg. 10,450 (1959).

<sup>95</sup> See S. REP. NO. 85-1983, at § 68 (1958), reprinted in 1958-3 C.B. 922, 1008-09. In August 1996, the SBJPA of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (to be codified in scattered sections of 26 U.S.C.), became law. The SBJPA of 1996 is effective beginning January 1, 1997. See *id.*

<sup>96</sup> See Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 *U. CIN. L. REV.* 1083, 1086-87 (1992).

<sup>97</sup> See I.R.C. §§ 1361-1378 (1994), amended by SBJPA of 1996, Pub. L. No. 104-188, 110 Stat. 1755.



shareholders<sup>98</sup> and imposes a “one class of stock” ownership requirement.<sup>99</sup> The resulting regulations thus restrict the availability of conduit taxation by adding another level of relatively arbitrary organizational attributes that a business must meet to satisfy the Subchapter S criteria.<sup>100</sup> Nevertheless, the S corporation remains the primary corporate-styled analog to partnerships and limited liability companies.<sup>101</sup> In addition to the criteria limiting its application, there are situations in which S corporations face significant tax disadvantages when compared to partnerships, including taxation of certain in-kind distributions, the inability to adjust the inside basis, and taxation of some contributions to the business.<sup>102</sup>

Senators Danforth and Pryor, members of the Senate Finance Committee, introduced legislation in 1993 that would remove many of the eligibility

<sup>98</sup> See *id.* § 1361(b)(1)(A)-(C), amended by SBJPA of 1996 §§ 1301, 1316(a)(1), 110 Stat. 1777, 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 *id.* § 1361(b)(1)(A), amended by SBJPA of 1996 § 1301, 110 Stat. at 1777. The SBJPA of 1996 increases the maximum number of eligible shareholders from 35 to 75. See SBJPA of 1996 § 1301, 110 Stat. at 1777 (effective Jan. 1, 1997). 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 § 1316(a)(1), 110 Stat. at 1785-86. Similarly, the corporation may not have owners who are nonresident aliens. See *id.* § 1361(b)(1)(C). This limitation poses significant barriers for offshore joint ventures.

<sup>99</sup> 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 *id.* § 1361(b)(1)(D), (2)(A), amended by SBJPA of 1996 § 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 *id.* § 1361(b)(1)(D). The restrictions also cause problems when investors contribute different types of assets or have different investment expectations. See *id.* (S corporations restricted to one class of stock). 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 *id.*; 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).

<sup>100</sup> See Parker, *supra* note 99, at 421 n.103.

<sup>101</sup> On the one hand, taxpayers currently can use S corporations to avoid the corporate-level tax on operating profits; on the other hand, limited liability companies theoretically offer heightened flexibility in accomplishing a more complicated economic sharing arrangement among equity owners than a straight pro rata sharing. Whereas S corporations can only issue a single class of stock, see I.R.C. § 1361(b)(1)(D), limited liability company members can share profits, losses, and distributions in the same, more complex manner as partners can share such partnership items. See *id.* § 734(b) (method of adjustment); *id.* § 743(b) (adjustment to basis of partnership property); *id.* § 754 (manner of electing optional adjustment to basis of partnership property). In addition, partnership tax treatment is generally preferential to S corporation tax treatment. See Parker, *supra* note 99, at 422-29. For example, partnership tax treatment permits more generous loss pass-through by including entity level debt in the partners' outside basis. See *id.* at 427-28. Also, S corporations, under current tax law, sometimes involve double-level tax resulting from shareholder transactions. See *id.* at 423. In contrast, partnership taxation treatment applicable to limited liability companies allows for avoidance of these problems. See I.R.C. § 734(b) (method of adjustment); *id.* § 743(b) (adjustment to basis of partnership property); *id.* § 754 (manner of electing optional adjustment to basis of partnership property).

<sup>102</sup> See Parker, *supra* note 99, at 422-29. Professor Parker describes these disadvantages in detail and concludes: “Beyond the fact that subchapter S may not be available to or practical for every business, it should also be noted that taxation under subchapter S may, in certain situations, be significantly greater than the taxation that would have been imposed had a partnership been utilized.” *Id.* at 422 (citation omitted).

requirements contained in Subchapter S,<sup>103</sup> and increase the number of permissible shareholders from thirty-five to fifty.<sup>104</sup> The S corporation would also be permitted to issue convertible debt and preferred stock,<sup>105</sup> though such stock could not be participating, could not have redemption and liquidation rights exceeding its issue price, and could not be convertible.<sup>106</sup> The proposal would allow an S corporation to own eighty percent or more of the stock of another corporation<sup>107</sup> and would expand the types of trusts that can own S corporation stock while easing some of the pitfalls caused by invalid elections and inadvertent terminations.<sup>108</sup> Moreover, it would apply C corporation rules for fringe benefit purposes<sup>109</sup> and eliminate the requirement of maintaining an AAA account for pre-1983 earnings and profits.<sup>110</sup>

On August 20, 1996, President Clinton signed into law the Small Business Job Protection Act of 1996 ("SBJPA of 1996"),<sup>111</sup> that, among other things, increases the maximum number of eligible shareholders from thirty to seventy-five,<sup>112</sup> allows S corporation stock to be held by "electing small business trusts,"<sup>113</sup> and allows S corporations to own eighty percent or more of a C corporation.<sup>114</sup> Although an improvement, these changes leave untouched the basic problems. First, while expanding the potential applicability of Subchapter S, the changes do not minimize, but rather change, the complexity of tax law as applied to these businesses. Second, simplification is lost because the tax consequences of operating a business under Subchapter S for corporations and Subchapter K for partnerships would still differ. More funda-

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103 See S Corporation Reform Act of 1993, S. 1690, 103d Cong. (1994). Senators Pryor and Danforth introduced the bill on November 11, 1993; the bill was not acted upon in the 103d Congress. On May 4, 1995, Senators Pryor and Hatch introduced the S Corporation Reform Act of 1995, S. 758, 104th Cong. (1995), and enjoyed its first hearing on June 19, 1995, before the Senate Finance Committee's Taxation Subcommittee. See *The S Corporation Reform Act of 1995: Hearings on S. 758 Before the Subcomm. on Taxation and I.R.S. Oversight of the Comm. on Finance*, 104th Cong. 3 (1995); *Present Law and Proposals Relating to Subchapter S Corporations and Home Office Deductions: Schedule for a Hearing on S. 758 Before the Subcomm. on Taxation and I.R.S. Oversight of the Senate Comm. on Finance*, 104th Cong. 1 (1995).

104 See S. 1690 § 101. Moreover, under the proposed legislation, all members of a single family would count as just one shareholder. See *id.* § 102. Tax exempt organizations, financial institutions, and nonresident aliens would be permitted to own corporation stock as well. See *id.* §§ 111-113.

105 See *id.* § 201.

106 See *id.* Unfortunately, the preferred stock allowed by proposed legislation regarding Code § 1361(c)(7)(B) would be required to have the worst attributes of both common stock and debt: as stock, it would fall behind all debt in bankruptcy; as nonparticipating and nonconvertible, it would lack the speculative charm of common stock. Indeed, such stock cannot even pay a premium on a redemption or liquidation. See *id.*

107 See *id.* § 221. The proposal would not, however, permit the related entities to file a consolidated return. See *id.*

108 See *id.* §§ 114, 211.

109 See *id.* § 222.

110 See *id.* § 226.

111 Pub. L. No. 104-188, 110 Stat. 1755 (to be codified in scattered sections of 26 U.S.C.). Sections 1301 to 1317 of the SBJPA of 1996 amended the Subchapter S rules. See *id.* §§ 1301-1317, 110 Stat. at 1777-87.

112 See *id.* § 1301, 110 Stat. at 1777.

113 *Id.* § 1302, 110 Stat. at 1777.

114 See *id.* § 1308, 110 Stat. 1782-83.

mentally, business owners would still be encouraged implicitly to use the entity classification that would produce the lowest tax bill, regardless of whether or not that entity provided the optimal organizational structure for the business.<sup>115</sup>

### B. Limited Partnerships and Master Limited Partnerships

New York ushered in the first limited partnership statute in 1822<sup>116</sup> and soon thereafter 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 every state.<sup>117</sup> In 1976, the Commissioners on Uniform State Laws approved a Revised Uniform Limited Partnership Act that most jurisdictions have adopted.<sup>118</sup>

Generally, a limited partnership is treated as a partnership under the tax law if at least two of the four corporate characteristic criteria are not present.<sup>119</sup> This treatment persists even though limited partners can exercise only limited control over the partnership and exercise no day-to-day control over the partnership's business.<sup>120</sup>

The *Kintner* regulations catalyzed the emergence of "master limited partnerships," which are large, syndicated tax-shelter limited partnerships<sup>121</sup> in which the equity participants enjoyed limited liability.<sup>122</sup> The limited partnerships generally obtained favorable pass-through treatment of income, gains, and losses by avoiding association classification under the new regulations.<sup>123</sup> The regulations designed to restrain access to corporate pension plan advantages, therefore, unwittingly enabled even a large, publicly traded,

<sup>115</sup> 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.

<sup>116</sup> See Act of Apr. 17, 1822, ch. 244, 1822 N.Y. Laws 259.

<sup>117</sup> See R. Kurt Wilke, Note, *Limited Partnership Control: A Reexamination of Creditor Reliance*, 60 IND. L.J. 515, 518 (1985).

<sup>118</sup> See Deborah A. DeMott, *Our Partners' Keepers? Agency Dimensions of Partnership Relationships*, in 58 LAW AND CONTEMPORARY PROBLEMS: PARTNERSHIPS 109, 115 (Deborah A. DeMott & J. Dennis Hynes eds., 1995); Symposium, *Limited Partnership Act*, 9 ST. MARY'S L.J. 441, 441 (1978).

<sup>119</sup> See *Larson v. Commissioner*, 66 T.C. 159, 185-86 (1976), *acq.*, 1979-2 C.B. 2; Treas. Reg. § 301.7701-2(a)(3), -3(b)(1) (1995). 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.

<sup>120</sup> See REVISED UNIF. LTD. PARTNERSHIP ACT § 303 (amended 1985), 6A U.L.A. 144-45 (1995). A limited partner's relationship to the partnership mirrors a shareholder's relationship to a corporation. See *id.* 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).

<sup>121</sup> For a discussion of the creation of the limited partnership association, see Schwartz, *supra* note 9, at 29-64.

<sup>122</sup> As to the limited liability of the large limited partnership, see REVISED UNIF. LTD. PARTNERSHIP ACT § 303, 6A U.L.A. 144-45.

<sup>123</sup> See Treas. Reg. §§ 301.7701-2(a)(3), -3(b)(1).

noncorporate entity formed as a limited partnership under state law to qualify as a partnership for federal tax purposes.<sup>124</sup>

Fearing unrestrained growth of tax-shelter limited partnerships, the Treasury modified again its regulations in 1977, retaining the corporate classification approach based upon factors of resemblance while adding certain secondary corporate characteristics against which the entity would have to be evaluated.<sup>125</sup> The Treasury, however, withdrew these regulations,<sup>126</sup> and, in 1980, issued proposed regulations that treated unlimited liability as a necessary, but not sufficient, condition for partnership classification.<sup>127</sup> The Treasury eventually withdrew these proposed regulations in 1982.<sup>128</sup> Following withdrawal of these regulations, the Service shifted emphasis to minimum capitalization requirements, which had been set forth in Revenue Procedure 72-13<sup>129</sup> and were reiterated in Revenue Procedure 89-12.<sup>130</sup>

Congress finally addressed the problem in 1987 with the enactment of Code § 7704.<sup>131</sup> Congress sought to restrain the proliferation of publicly traded limited partnerships as a means of increasing the number of investors eligible to benefit from pass-through tax treatment of business entities.<sup>132</sup> Section 7704 reclassified most publicly traded limited partnerships as corporations for tax purposes.<sup>133</sup> The life and death saga of the master limited partnership provides a classic example of the intrinsic dangers and frailty of a Treasury- and Service-dictated organizational regime: with one pen stroke the Treasury and the Service all but killed the master limited partnership.

### C. Limited Liability Partnerships

The development of the “limited liability partnership” or “registered limited liability partnership” (jointly “LLP”) highlights the rush toward limited liability havens. An LLP is a general partnership that is subject to usually a one paragraph statutory provision restricting its liability if appropriate documentation is filed with a state.<sup>134</sup> Although LLPs were tailored for professional service practices, they have proliferated—and may continue to proliferate—outside of the professional domain.

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<sup>124</sup> See *id.*

<sup>125</sup> See Prop. Treas. Reg. §§ 301.7701-1 to -3, 42 Fed. Reg. 1038 (1977).

<sup>126</sup> See 42 Fed. Reg. 1489 (1977).

<sup>127</sup> See Prop. Treas. Reg. § 301.7701-2(a)(2) to -2(a)(4), -2(g) example (1), 45 Fed. Reg. 70,909 (1980).

<sup>128</sup> See I.R.S. News Release IR-82-145 (Dec. 16, 1982).

<sup>129</sup> See Rev. Proc. 72-13, 1972-1 C.B. 735.

<sup>130</sup> See Rev. Proc. 89-12, 1989-1 C.B. 798.

<sup>131</sup> See 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).

<sup>132</sup> See I.R.C. § 7704.

<sup>133</sup> See *id.*; 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 Code § 7704); Sheldon I. Banoff, *Avoiding Publicly Traded Partnerships Status: Living and Dying with Notice 88-75*, 66 TAXES 561 (1988) (advising how to avoid publicly traded partnership status under new Service guidelines).

<sup>134</sup> Thus, LLPs do not require formation of a new organization or execution of new constituent documents.

Generally, the liability protection accorded LLP owners is not as extensive as that accorded their corporate counterparts. Although many statutes only protect partners against liability for tort debt—but not contract debt—several states' statutes—including Minnesota's and New York's—limit liability for entity debt under all theories.<sup>135</sup> The Service has ruled that New York LLPs are partnerships for federal income tax purposes despite such absolute limited liability.<sup>136</sup>

In limiting the liability of general partners, but as an overlay on the well-known partnership law foundation, such legislation providing absolute limited liability could produce renewed interest in the general partnership. Some of the LLP statutes apply only to partnerships of persons rendering professional services.<sup>137</sup> Others restrict the protection to limiting personal liability for the liabilities of copartners, without affecting liability for other obligations of the partnership.<sup>138</sup> LLP amendments to the general partnership laws that limit liability for all types of activities and for all partnership obligations,<sup>139</sup> if adopted by a number of states,<sup>140</sup> would provide competition for the limited liability company, at least in the context of close relationships where centralized management is not desired. The LLP movement establishes some interesting dynamics in the choice of business entity. If the participants seek a partnership structure, but with limited liability, the LLP is available and offers the benefits of a greater degree of certainty. In addition, if the nature and application of interowner fiduciary duties is important to the organizers, the LLP may be desired as it is subject to the existing state partnership regime.

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<sup>135</sup> See MINN. STAT. ANN. § 323.14 (West 1995); N.Y. PARTNERSHIP LAW § 26(b) (McKinney Supp. 1996); see also Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1087-1102 (discussing the Minnesota and New York LLP statutes).

<sup>136</sup> See Rev. Rul. 95-55, 1995-35 I.R.B. 13 (concluding that a New York LLP is classified as a partnership for federal tax purposes).

<sup>137</sup> See, e.g., NEV. REV. STAT. ANN. § 87.020.7 (Michie 1995) (LLP not limited to professional services); NY PARTNERSHIP LAWS § 121-1500(a) (McKinney Supp. 1995) (LLP not limited to professional services). But see CAL. CORP. CODE §§ 15001-15800 (West Supp. 1996) (limiting LLPs to accountants and attorneys); OR. REV. STAT. § 68.110 (1995) (limiting LLPs to defined professions).

<sup>138</sup> See, e.g., VA. CODE ANN. § 50-15(2)(B)-(C) (Michie Supp. 1996) (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." *Id.* § 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." *Id.* § 50-15(2)(C).

<sup>139</sup> See, e.g., MINN. STAT. ANN. § 323.14.

<sup>140</sup> Until a number of states adopt LLP legislation, the LLP will suffer from the limited liability company's initial uncertainty in recognizing the limited liability shield in interstate transactions. See *infra* notes 141-177 and accompanying text. As of September 1, 1994, 17 states and the District of Columbia had enacted LLP legislation. See Elizabeth G. Hester, *Practical Guide to Registered Limited Liability Partnerships*, in 5 STATE LIMITED LIABILITY: COMPANY & PARTNERSHIP LAWS LLP-1, LLP-2 to -3 (Michael A. Bamberger & Arthur J. Jacobson eds., Supp. I 1996). In addition, three states enacted provisions recognizing foreign LLPs imported into their jurisdictions, in the absence of a host jurisdiction LLP enabling statute. See *id.* at LLP-2.

#### D. The Tentative Ascendancy of the Limited Liability Company

As a final tribute to the tax-driven nature of business organization law and the power of the *Kintner* regulations, the limited liability company ("LLC") has caused a minor business revolution over the past decade. The history of the LLC has received exhaustive scholarly attention;<sup>141</sup> accordingly, our discussion here is an overview of the essential facts.

In 1977, Wyoming adopted the first modern<sup>142</sup> LLC act in the United States, creating a new business entity that would provide both limited liability and federal partnership income tax treatment.<sup>143</sup> Florida followed with LLC legislation in 1982.<sup>144</sup> In 1982, the Service 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.<sup>145</sup>

Initial concerns about the federal income tax classification of LLCs were appeased with the completion of the Service study and issuance in 1988 of a landmark revenue ruling granting a favorable partnership classification for the Wyoming LLC.<sup>146</sup> With the tax consequences of the LLC more assured, Colorado and Kansas started the second wave of LLC legislation by enacting statutes in 1990.<sup>147</sup> Four states enacted LLC statutes in 1991,<sup>148</sup> ten did so in 1992,<sup>149</sup> twenty adopted legislation in 1993,<sup>150</sup> ten in 1994,<sup>151</sup> and one addi-

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<sup>141</sup> See *infra* note 156 (referring to the large number of articles previously written about the LLC).

<sup>142</sup> 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.

<sup>143</sup> 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 (Michie 1989 & Supp. 1996)); Philip P. Whynott, *North American Trade Treaty Stimulates Interest in US 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 beschränkter 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).

<sup>144</sup> See Richard Johnson, Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387, 387 (1983).

<sup>145</sup> See Gazur & Goff, *supra* note 142, at 445.

<sup>146</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

<sup>147</sup> See *infra* note 153.

<sup>148</sup> Nevada, Texas, Utah, and Virginia. See *infra* note 153.

<sup>149</sup> Arizona, Delaware, Illinois, Iowa, Louisiana, Maryland, Minnesota, Oklahoma, Rhode Island, and West Virginia. See *infra* note 153.

<sup>150</sup> 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 *infra* note 153.

<sup>151</sup> Alaska, California, Kentucky, Mississippi, New York, Ohio, Pennsylvania, South Carolina, Tennessee, and Washington. See *infra* note 153.

tional state adopted LLC legislation in 1995.<sup>152</sup> Presently, forty-eight states have some version of LLC legislation.<sup>153</sup>

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<sup>152</sup> Massachusetts enacted an LLC statute effective January 1, 1996. See Massachusetts Limited Liability Company Act, 1995 Mass. Acts ch. 281 (codified at MASS. ANN. LAWS ch. 156C, §§ 1-68 (Law Co-op. Supp. 1996)).

<sup>153</sup> See Alabama Limited Liability Company Act, No. 724, 1993 Ala. Acts 1425 (codified at ALA. CODE §§ 10-12-1 to -61 (1994)); Alaska Limited Liability Act, 1994 Alaska Sess. Laws ch. 99 (codified at ALASKA STAT. §§ 10.50.010-995 (Michie Supp. 1995)); Act of June 2, 1992, ch. 113, 1992 Ariz. Sess. Laws 394 (codified at ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (West Supp. 1996)); Small Business Entity Pass Through Act, No. 1005, 1993 Ark. Acts 2928 (codified at ARK. CODE ANN. §§ 4-32-101 to -1316 (Michie 1996)); Beverly-Killea Limited Liability Company Act, 1994 Cal. Stat. ch. 1200 (codified at CAL. CORP. CODE §§ 17000-17705 (West Supp. 1996)); Colorado Limited Liability Company Act, ch. 58, 1990 Colo. Sess. Laws 414 (codified as amended at COLO. REV. STAT. ANN. §§ 7-80-101 to -913 (West Supp. 1996)); Connecticut Limited Liability Company Act, No. 267, 1993 Conn. Acts 884 (Reg. Sess.) (codified at CONN. GEN. STAT. ANN. §§ 34-100 to -242 (West Supp. 1996)); Act effective Oct. 1, 1992, ch. 434, 68 Del. Laws 1329 (codified as amended at DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (1993 & Supp. 1994)); Florida Limited Liability Company Act, 1993 Fla. Laws ch. 284 (codified at FLA. STAT. ANN. §§ 608.401-514 (West Supp. 1996)); Georgia Limited Liability Company Act, No. 174, 1993 Ga. Laws 123 (codified as amended at GA. CODE ANN. §§ 14-11-100 to -1109 (1994 & Supp. 1996)); Act of March 26, 1993, ch. 224, 1993 Idaho Sess. Laws 760 (codified as amended at IDAHO CODE §§ 53-601 to -672 (1994 & Supp. 1996)); 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. 1996)); 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 (West 1994 & Supp. 1996)); Iowa Limited Liability Company Act, ch. 1151, 1992 Iowa Acts 238 (codified at IOWA CODE ANN. §§ 490A.100-1601 (West Supp. 1996)); Kansas Limited Liability Company Act, ch. 80, 1990 Kan. Sess. Laws 585 (codified at KAN. STAT. ANN. §§ 17-7601 to -7651 (1995)); Kentucky Limited Liability Company Act, ch. 389, 1994 Ky. Acts 1087 (codified at KY. REV. STAT. ANN. §§ 275.001-455 (Banks-Baldwin Supp. 1996)); 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. 1996)); Maine Limited Liability Company Act, ch. 718, 1993 Me. Laws 2168 (codified at ME. REV. STAT. ANN. tit. 31, §§ 601-762 (West 1996)); 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 (1993 & Supp. 1996)); Michigan Limited Liability Company Act, No. 23, 1993 Mich. Pub. Acts 138 (codified at MICH. COMP. LAWS ANN. §§ 450.4101-5200 (West Supp. 1996)); Minnesota Limited Liability Company Act, ch. 517, 1992 Minn. Laws 1168 (codified as amended at MINN. STAT. ANN. §§ 322B.01-960 (West 1995 & Supp. 1997)); Mississippi Limited Liability Company Act, ch. 402, 1994 Miss. Laws 215 (codified at MISS. CODE ANN. §§ 79-29-101 to -1204 (1996)); Missouri Limited Liability Company Act, 1993 Mo. Laws 965 (codified at MO. ANN. STAT. §§ 347.010-.740 (West Supp. 1996)); Montana Limited Liability Company Act, ch. 120, 1993 Mont. Laws 269 (codified at MONT. CODE ANN. §§ 35-8-101 to -1307 (1995)); Limited Liability Company Act, LB 121, 1993 Neb. Laws 333 (codified as amended at NEB. REV. STAT. ANN. §§ 21-2601 to -2653 (Michie 1995 & Supp. 1996)); Limited Liability Company Act, ch. 442, 1991 Nev. Stat. 1184 (codified as amended at NEV. REV. STAT. ANN. §§ 86.010-571 (Michie 1994 & Supp. 1995)); Act of June 23, 1993, ch. 313, 1993 N.H. Laws 323 (codified at N.H. REV. STAT. ANN. §§ 304-C:1-85 (1995)); 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. 1996)); 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. 1996)); New York Limited Liability Company Act, ch. 576, 1994 N.Y. Laws 1347 (codified at N.Y. LTD. LIAB. CO. LAW §§ 101-1403 (McKinney Supp. 1996)); 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 (1993)); North Dakota Limited Liability Company Act, ch. 92, 1993 N.D. Laws 390 (codified at N.D. CENT. CODE §§ 10-32-01 to -155 (1995)); Act effective July 1, 1994, 1994 Ohio Laws 634 (codified at OHIO REV. CODE ANN. §§ 1705.01-.58 (Anderson Supp. 1995)); Oklahoma Limited Liability Company Act, ch. 148, 1992 Okla. Sess. Laws 483 (codified at

Structurally, the LLC represents a new hybrid to the business entity montage in its attempt to balance limited liability with conduit taxation. Unlike a limited partnership, in which a general partner has personal liability to third parties for the recourse debts of the partnership,<sup>154</sup> an LLC has no such owner who bears that responsibility for LLC debts.<sup>155</sup>

Many LLC codes derive from a partnership organizational framework,<sup>156</sup> reflecting both the form of entity that the parties would have ultimately chosen<sup>157</sup> and the need to ensure the classification of the LLC as a "partnership" for federal income tax purposes. The common LLC statutory requirements of multiple members,<sup>158</sup> the potential for dissolution<sup>159</sup> upon

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OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West Supp. 1997)); Oregon Limited Liability Company Act, ch. 173, 1993 Or. Laws 435 (codified at OR. REV. STAT. §§ 63.001-.990 (Supp. 1994)); Limited Liability Company Law of 1994, No. 106, 1994 Pa. Laws 703 (codified at 15 PA. CONS. STAT. ANN. §§ 8901-8998 (West 1995)); 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. 1995)); South Carolina Limited Liability Company Act, No. 448, 1994 S.C. Acts 4856 (codified at S.C. CODE ANN. §§ 33-43-101 to -1409 (Law Co-op. Supp. 1995)); Act of March 13, 1993, ch. 344, 1993 S.D. Laws 535 (codified at S.D. CODIFIED LAWS §§ 47-34-1 to -59 (Michie Supp. 1996)); Tennessee Limited Liability Company Act, ch. 868, 1994 Tenn. Pub. Acts 654 (codified at TENN. CODE ANN. §§ 48-201-101 to -248-606 (Supp. 1995)); Act effective Aug. 26, 1991, ch. 901, 1991 Tex. Gen. Laws 3161 (codified at TEX. REV. CIV. STAT. ANN. art. 1528n (West Supp. 1997)); Utah Limited Liability Company Act, ch. 258, 1991 Utah Laws 991 (codified as amended at UTAH CODE ANN. §§ 48-2b-101 to -158 (1994 & Supp. 1996)); Virginia Limited Liability Company Act, 1991 Va. Acts ch. 168 (codified at VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993)); Washington Limited Liability Company Act, ch. 211, 1994 Wash. Laws 1018 (codified at WASH. REV. CODE ANN. §§ 25.15.005-.902 (West Supp. 1997)); Uniform Limited Liability Company Act, 1996 W. Va. Acts ch. 256 (codified at W. VA. CODE §§ 31B-1-101 to -13-1306 (1996)); Act of December 14, 1993, ch. 112, 1993 Wis. Laws 708 (codified at WIS. STAT. ANN. §§ 183.0102-.1305 (West Supp. 1995)); Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 537 (codified as amended at WYO. STAT. ANN. §§ 17-15-101 to -144 (Michie 1989 & Supp. 1996)).

Hawaii's LLC statute becomes effective April 1, 1997. See Hawaii Limited Liability Company Act, 1996 Haw. Sess. Laws ch. 92 (codified at HAW. REV. STAT. ANN. §§ 428-101 to -1302 (Michie, WESTLAW through 1996 Reg. Sess.)).

<sup>154</sup> See REVISED UNIF. LTD. PARTNERSHIP ACT § 303 (amended 1985), 6A U.L.A. 144-45 (1995).

<sup>155</sup> See, e.g., MD. CODE ANN., CORPS. & ASS'NS § 4A-301 ("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 ("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 . . .").

<sup>156</sup> 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 142 (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 LLC's to other business organization forms and analyzing state LLC statutes).

<sup>157</sup> 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 . . .").

<sup>158</sup> 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 COMPA-



events occurring with regard to members, and the limited transferability of ownership interests, all aim to ensure the desired partnership income tax classification.<sup>160</sup> But 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 fresh issues anew.

Indeed, several commentators have expressed serious reservations about the LLC.<sup>161</sup> 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!"<sup>162</sup> 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.<sup>163</sup>

The desirability of an LLC generally decreases as its number of members increases because of the tax sensitive requirement of potential dissolution with respect to all members. Nevertheless, the Service has recently approved LLC continuity provisions tied to events occurring with respect to only member-managers, with majority approval of the members for continuation, although that issue continues to be in flux.<sup>164</sup> This instability underscores the LLC's intrinsic vulnerability to the whims of both the Treasury and the Service.

The corporate characteristic of free transferability of interests illustrates another potential problem with LLCs when the owners of an organization who possess nonfreely transferable interests are related either by blood or common ownership. A close relationship among the owners might preclude

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NIES § 16.19 (1995). The Service will 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.

<sup>159</sup> 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), approved by the National Conference of Commissioners on Uniform State Laws at its meeting held July 29 to August 5, 1994.

<sup>160</sup> *See* Susan P. Hamill, *The Limited Liability Company: A Midpoint Evaluation*, in 1994-1 N.Y.U. 52D INST. ON FED. TAX'N 1-1, § 1.02 (discussing classification of LLCs as partnerships).

<sup>161</sup> *See, e.g.*, Burke, *supra* note 62 (discussing the "uncertain future" of limited liability companies).

<sup>162</sup> Rands, *supra* note 6, at 32 (internal footnote omitted).

<sup>163</sup> *See id.* at 36-37 (noting the uncertainties regarding, among others, veil piercing, fiduciary duties, and member requirements).

<sup>164</sup> On January 17, 1995, the Service issued Rev. Proc. 95-10, 1995-1 C.B. 501, specifying the conditions under which it would consider a favorable ruling request relating to classification of an LLC as a partnership for federal income tax purposes. *See id.* § 1.01. The revenue procedure permits dissolution events relating solely to member-managers, but upon dissolution consent to continue must be exercised by "not less than a majority in interest of the remaining members." *Id.* § 5.01. The revenue procedure includes many dissolution events—death, insanity, bankruptcy, retirement, resignation, or expulsion—unless the taxpayer clearly establishes that the event or events selected provide a meaningful possibility of dissolution. *See id.* § 5.01(2).

the organization from lacking the corporate characteristic of free transferability of interests if the relationship of the owners could negate any transfer restrictions.<sup>165</sup> The problem will arise, for example, when the ownership interests of an LLC are owned entirely by a single economic interest, such as an individual and the individual's wholly-owned corporation.<sup>166</sup>

Practically, the Treasury regulations governing an LLC's continuity of life<sup>167</sup> could impose a significant burden: any time any of the enumerated events occurs, a unanimous—or majority—vote of the remaining owners would be necessary to continue the LLC. In an LLC with many owners, the likelihood of the event's occurrence and the difficulty of obtaining the requisite consent to continue may increase to an unacceptable level.<sup>168</sup> Pursuant to these regulations, an organization will lack continuity of life if it is dissolved upon bankruptcy, death, dissolution, expulsion, incapacity, or withdrawal of any owner, notwithstanding any vote to the contrary by all or any portion of the remaining owners.<sup>169</sup> To avoid the corporate—and potential double tax—characteristic of continuity of life, the organization's operating agreement, articles of organization, or both, or the operative state law, must contain a provision that the foregoing events will cause dissolution of the organization, without further action of the owners.<sup>170</sup> While a majority of

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165 Free transferability of interests will be lacking if such a transfer requires consent of a majority of nontransferring members. See Rev. Proc. 95-10, § 5.02, 1995-1 C.B. 501, 504; Rev. Proc. 92-33, § 2.02, 1992-1 C.B. 782, 782.

166 In Revenue Ruling 77-214, the Service concluded that a German *GmbH* possessed the corporate characteristic of free transferability of interests because its members were two wholly-owned domestic subsidiaries of a single parent corporation. See Rev. Rul. 77-214, 1977-1 C.B. 408. In that situation, the Service reasoned, the parent corporation "could make all the transfer decisions for its wholly-owned subsidiaries, despite any provision in the memorandum of association that might indicate otherwise." See *id.*

Several years later, in Revenue Ruling 93-4, the Service reiterated much of the Revenue Ruling 77-124 conclusion, noting that a provision requiring consent of the members was meaningless when all of the members were commonly controlled, and that such a requirement thus could not cause the entity to lack free transferability of interest. See Rev. Rul. 93-4, 1993-1 C.B. 225. The Service also indicated, however, that free transferability could still be avoided, even if the members are commonly controlled, if the entity's organizational documents either (i) flatly prohibit transfers of interest, or (ii) provide that a transfer triggers dissolution. See *id.* Based upon this statement, commentators have suggested that if all the owners are to be commonly controlled and free transferability of interest is to be avoided, the documents must be drafted so that transfers are either flatly prohibited or dissolution occurs upon any transfer. See CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 2.07[5], at 2-111 (1994).

167 See Treas. Reg. § 301.7701 (1995).

168 Compare the limited partnership, in which typically only the event's occurrence with respect to the last remaining general partner will trigger a dissolution. See *id.* § 301.7701-3(b).

169 See *id.* § 301.7701-2(b). Treasury Regulation § 301.7701-2 provides that continuity of life does not exist if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization. See *id.* § 301.7701-2. The regulation further states that dissolution for this purpose does not mean termination of the business but rather a change in the relationship of its members as determined under local law. See *id.* Pursuant to Treasury Regulation § 301.7701-2(b), the fact that an entity is given a fixed term of years as a life does not destroy continuity of life. See *id.* § 301.7701-2(b).

170 See *id.* § 301.7701-2(b).

states appear to adopt this rule,<sup>171</sup> even absent such a provision in the operating agreement or articles of organization, some states, such as New York, permit variations.<sup>172</sup> An explicit provision best assures that an organization controlled by a single person or entity, in a jurisdiction such as New York, will lack continuity of life.<sup>173</sup>

The problem of linking management structure and tax status is exemplified under current Treasury procedure. Revenue Procedure 95-10 suggests that as long as managers are not designated or elected, any internal or contractual agreement among the owners as to decisionmaking—such as designation of an executive or management committee—will not result in centralized management.<sup>174</sup> Treasury regulations emphasize that in order for management to be centralized, the management powers must be exclusive.<sup>175</sup> For example, since all owners of a general partnership have apparent authority to bind the partnership, no manager could have exclusive authority.<sup>176</sup> In this regard, if the owners of an LLC have and retain the authority to bind the LLC as to third parties without notice, then perhaps there can be no centralization of management even though managers may be appointed.<sup>177</sup>

The LLC is currently at a crossroads in its development: although forty-eight states have adopted LLC legislation, the statutes lack uniformity. At best, the Uniform Limited Liability Company Act may promote some uniformity and predictability. The underlying problem nevertheless has been skirted: obsolete tax strictures have compelled state legislatures to arrive at suboptimal forms of business organizations.

### *E. Further Efforts of State Experimentation*

In 1990, the Delaware legislature passed the Delaware Business Trust Act, radically updating an old form of unincorporated association—the Massachusetts or business trust—to empower entrepreneurs with greater freedom to structure their businesses.<sup>178</sup> In 1995, Wyoming enacted a similar

<sup>171</sup> See, e.g., MINN. STAT. ANN. § 322B.80(5) (West 1995 & Supp. 1997) (“A limited liability company dissolves upon the occurrence . . . of an event that terminates the continued membership of a member in the limited liability company . . .”).

<sup>172</sup> The New York Limited Liability Company Law allows for the managers to continue the LLC by vote of the majority of interests remaining unless a prohibition in the operating agreement or articles of incorporation states otherwise. See New York Limited Liability Company Act, ch. 576, § 701, 1994 N.Y. Laws 1347, 1376-77.

<sup>173</sup> See Rev. Proc. 95-10, § 5.01, 1995-1 C.B. 501, 504.

<sup>174</sup> See *id.* § 1.03. Section 1.03 of Revenue Procedure 95-10 states that “[i]f the applicable statute allows for management by one or more designated persons, managers are those persons designated or elected by the members to act on behalf of the LLC.” *Id.*

<sup>175</sup> See Treas. Reg. § 301.7701-2(c) (“An organization has centralized management if any person . . . has continuing exclusive authority to make the management decisions necessary . . .”).

<sup>176</sup> See *id.*

<sup>177</sup> See *id.* § 301.7701-2(c)(4).

<sup>178</sup> See Delaware Business Trust Act, ch. 297, 67 Del. Laws 682 (codified as amended at DEL. CODE ANN. tit. 12, §§ 3801-3820 (Michie 1995)). For an excellent overview of these laws, see Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, 66 U. COLO. L. REV. 881 (1995).

counterpart.<sup>179</sup> These two statutes represent a highly flexible form of entity organization: participants in a business trust have virtually limitless discretion in crafting the internal structure of a limited liability entity.<sup>180</sup>

A statutory trust may be either publicly or privately traded;<sup>181</sup> beneficial owners contribute capital<sup>182</sup> and enjoy limited liability to the same extent as shareholders of corporations or members of LLCs.<sup>183</sup> The business and affairs of a Wyoming statutory trust are “managed by or under the direction of its trustees.”<sup>184</sup> As to the voting power of the beneficial owners, the act provides unlimited flexibility to the organizers in specifying procedures for trustee selection and direction.<sup>185</sup> There is no inherent right of beneficial owners to vote on trustee selection, mergers, asset sales, dissolution, the creation of a subsidiary statutory trust, the creation of a new class of beneficial interests, or even amendment of the governing instrument.<sup>186</sup> Any voting rights of beneficial owners must be specified in the trust’s governing instrument and trustees may unilaterally file amendments to the trust certificate.<sup>187</sup>

Suits against trustees for a breach of their duties are also to be controlled by the governing instrument. The Wyoming Act notes that “[t]o the extent that . . . a trustee has duties, including fiduciary duties . . . [they] may be expanded or restricted by provisions in the governing instrument.”<sup>188</sup> Beneficial owners can bring derivative actions, if the trustees refuse—or are unlikely to agree—to act,<sup>189</sup> “subject to additional standards and restrictions . . .

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179 See Wyoming Statutory Trust Act, ch. 16, 1995 Wyo. Sess. Laws 17 (codified at WYO. STAT. ANN. §§ 17-16-1534, -23-101 to -302 (Michie Supp. 1996)). Although the Delaware and Wyoming Acts are similar, important differences exist, including the Delaware requirement that there be a resident Delaware trustee (Wyoming only requires a resident agent for service of process); the Wyoming requirement of an annual report and annual fee (Delaware has neither requirement); the Delaware default provision that beneficial interests are freely transferable (the Wyoming default rule is similar to its LLC rule); and the Wyoming default rule on trustee liability, which includes a business judgment standard of care (Delaware is silent on the issue and may have as a default rule a prudent person standard). See DEL. CODE ANN. tit. 12, § 3805(d) (beneficiaries’ interests freely transferable); *id.* § 3807 (resident trustee requirement); WYO. STAT. ANN. § 17-23-109(a)(ii) (resident agent for service of process); *id.* § 17-23-117(c) (annual fee); *id.* § 17-23-105 (trustee liability).

180 See Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 126-27 (1991) (noting that the “Delaware business trust statute demonstrates that the states are approaching full-fledged recognition of the contract theory of the corporation”).

181 A statutory trust may be organized for “any lawful purpose . . . whether or not conducted for profit.” WYO. STAT. ANN. § 17-23-103.

182 See *id.* § 17-23-104.

183 See *id.* § 17-23-105(a).

184 *Id.* § 17-23-108(a).

185 See *id.* § 17-23-108(b).

186 See *id.* The section specifies that the trust instrument—which creates the trust and provides for the governance of its affairs—may “without limitation” allocate these rights among beneficial owners and trustees. See *id.*

187 See *id.* § 17-23-114(c).

188 *Id.* § 17-23-108(c). Generally, a trust instrument may relieve a trustee of liability for breaches of trust unless the breach is committed in bad faith, intentionally, or with reckless indifference to the interests of the beneficiaries, or if a trustee has derived a personal profit. See RESTATEMENT (SECOND) OF TRUSTS § 222(l) (1959) (“[T]he trustee . . . can be relieved of liability for a breach of trust.”).

189 See WYO. STAT. ANN. § 17-23-120(a). The complaint must set forth with particularity

in the governing instrument, including, without limitation, the requirement" of a minimum ownership interest.<sup>190</sup> Subject to standards in a governing instrument, a statutory trust "shall have the power to indemnify and hold harmless any trustee or beneficial owner . . . from and against any and all claims and demands whatsoever."<sup>191</sup>

The Wyoming and Delaware Acts include the following language: "It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of governing instruments."<sup>192</sup> The Wyoming Act provides that "[e]xcept to the extent otherwise provided in the governing instrument or in this chapter, the laws of this state pertaining to trusts are hereby made applicable to statutory trusts."<sup>193</sup> Thus, even though general trust doctrine may allow beneficial owners to sue on their own behalf for trustees' breaches of duty,<sup>194</sup> allow a court to review trustee decisions under an abuse of discretion standard,<sup>195</sup> or allow a court to remove and replace a trustee,<sup>196</sup> these doctrines can be superseded by a trust's governing instrument.

#### F. *The Demise of the Current Organizational Regime*

The justifications for our existing system of taxing business organizations are apparently limited to history and a need for revenue. The current tax system discriminates between debt and equity, between distributed and retained earnings, and between corporations and pass-through entities. The result is economic inefficiencies and an overemphasis on tax planning. Arguably, the income of businesses should be taxed once, whether or not distributed, at the marginal rates of the owners.<sup>197</sup> This result has been haphazardly achieved under the partnership and Subchapter S tax rules.

These tax-driven strictures have spawned an essentially new entity, the LLC, in virtually every state,<sup>198</sup> thereby necessitating the creation of a whole new body of law with all the resulting uncertainty. This upheaval has happened almost by accident and not as part of a purposeful effort to accomplish some social or economic goal that could not have been achieved through

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the effort by the beneficial owner to secure action by the trustees or the reasons for not making the effort. *See id.* § 17-23-120(c). The plaintiff must be a beneficial owner or a successor to a beneficial owner who held the interest at the time of the wrong. *See id.* § 17-23-120(b).

<sup>190</sup> *Id.* § 17-23-120(e).

<sup>191</sup> *Id.* § 17-23-121(a).

<sup>192</sup> DEL. CODE ANN. tit. 12, § 3819(b) (1990); WYO. STAT. ANN. § 17-23-302(b).

<sup>193</sup> WYO. STAT. ANN. § 17-23-113.

<sup>194</sup> *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 198 (1959) (legal remedies of beneficiary); *id.* § 199 (equitable remedies of beneficiary).

<sup>195</sup> *See id.* § 187 (court review of exercise of trustee discretion under an abuse of discretion standard); *id.* § 382 (removal of trustees).

<sup>196</sup> *See id.* § 199(d), (e).

<sup>197</sup> *See, e.g.*, Charles E. McLure, Jr., *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532, 542 (1975) ("Under an ideal system of integration, a shareholder would pay the same rate of tax on corporate-source income, at the margin, as he pays on income from any other . . . source . . ."). *But see* TREASURY REPORT, *supra* note 70, at 12-13 (adopting the view that all capital income should be taxed at the same rate rather than at the rates of the shareholders).

<sup>198</sup> *See supra* note 153 (listing states that have adopted LLC statutes).

corporations, whose law has been developed with great sophistication for generations, if not centuries.

A long-term failure of Congress, the Treasury, and the Service to define and articulate in the tax law the basic policies implicit in business taxation has forced state law makers to adapt to a wholly formalistic means of determining tax status. Although the LLC allows owners to achieve both pass-through status and limited liability, it does so by forcing a turn away from the well-established jurisprudence of corporate and partnership law, devising instead a new branch of law that exists only because the tax classification rules are so troublesome.

In recognition of these problems, the Treasury and the Service now appear willing to permit taxpayers to choose the kind of treatment they desire: pass-through or two-level taxation. The Service first indicated its flexibility in publishing a revenue ruling permitting classification of LLCs as partnerships—and therefore pass-through entities<sup>199</sup>—even though the Treasury's own classification regulations could have been amended to provide otherwise—most recently, in the Treasury's consideration of elective treatment for nonpublicly traded LLCs. Congress has thus far remained silent on this decision.

On December 18, 1996, the Treasury finalized its revolutionary "Simplification of Entity Classification Rules" ("1996 Final Regulations") that became effective January 1, 1997. The 1996 Final Regulations replace the existing classification regulations with a simplified regime that is elective for certain business organizations.<sup>200</sup> Stressing that, under the current system, "taxpayers and the IRS must expend considerable resources on classification issues,"<sup>201</sup> the Treasury and the Service aimed "to replace the increasingly formalistic rules . . . with a much simpler approach that generally is elective."<sup>202</sup>

The 1996 Final 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, noting that a business entity that is publicly traded is taxable as a corporation.<sup>203</sup> Thus, the 1996 Final Regulations continue to highlight "publicly traded" status as a determinative factor of entity classification.<sup>204</sup>

According to the 1996 Final Regulations, an eligible entity with at least two members can elect to be classified as an association (with entity tax sta-

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<sup>199</sup> See Rev. Rul. 88-76, 1988-2 C.B. 360 (concluding that an unincorporated organization operating under state LLC law is a partnership for federal tax purposes).

<sup>200</sup> See Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584, 66,584 (1996) (to be codified at 26 C.F.R. pt. 301).

<sup>201</sup> Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,990 (1996) ("1996 Proposed Regulations") (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").

<sup>202</sup> *Id.*

<sup>203</sup> See 26 C.F.R. § 301.7701-2(b); see also 1996 Proposed Regulations, 61 Fed. Reg. at 21,991.

<sup>204</sup> See § 301.7704; 1996 Proposed Regulations, 61 Fed. Reg. at 21,991.

tus) or a partnership (with conduit tax status), and an eligible entity with a single owner may elect to be classified as an association or to be disregarded as an entity separate from its owner.<sup>205</sup> Under the 1996 Final Regulations' default rules, a newly formed domestic eligible entity will be classified as a partnership if it has two or more members unless an election is filed to classify the entity as an association.<sup>206</sup> Thus, the 1996 Final Regulations provide a default rule that approximates owners' expectations more closely.<sup>207</sup> Under the 1996 Final Regulations, eligible entities existing prior to the effective date of the regulations choosing to retain their current classification need not file an election.<sup>208</sup>

Generally, an eligible entity not intending to adopt the classification provided by the applicable default provision—or that seeks to change its classification—may file an election to obtain the chosen classification by filing with the appropriate service center.<sup>209</sup> An eligible entity electing to change its classification “cannot change its classification by election again during the sixty months succeeding the effective date of the election.”<sup>210</sup>

We applaud the 1996 Final Regulations as the first step in exalting substance over form. The task remaining is to identify an optimal business organization structure that harnesses this long awaited opportunity to focus on the substance of business organization law rather than formal characteristics.

### *III. A Proposal for Unifying Business Organization Law*

This Part attempts to harness the fundamental, underlying nature of business firms and to distill the essential character of business organization law toward arriving at a framework for unifying business organization law. Accordingly, Part III.A explores the nature and role of business organization law. Part III.B considers when, if ever, double-taxation should be imposed upon a firm. Part III.C reformulates the organizational and taxation components discussed above and presents a proposal for a unified business organization law.

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<sup>205</sup> See § 301.7701-3(a). “Eligible entity” is referred to in the regulation as a business entity that is not required to be classified as a corporation under § 301.7701-2(b), (3)-(8).

<sup>206</sup> See *id.* 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 *id.*

<sup>207</sup> See 1996 Proposed Regulations, 61 Fed. Reg. at 21,992.

<sup>208</sup> See § 301.7701-3(a).

<sup>209</sup> See *id.*

<sup>210</sup> § 301.7701-3(c)(1)(iv).

### A. *The Role of Business Organization Law*

Business firms are at once entities<sup>211</sup> susceptible to “reification”<sup>212</sup> and “persons”<sup>213</sup> capable of entering into contracts, owning real and personal property, suing and being sued, appointing agents, transacting business, and even making payments and charitable donations in the “name of the corporation.”<sup>214</sup> Originally business organizations such as corporations were considered as created only by a “concession” of rights to a business “entity” by the political state.<sup>215</sup> Today, however, most commentators accept a “nexus” of contracts theory of firms, positing that a firm is merely the aggregate of the many contractual relationships of which it is composed.<sup>216</sup>

211 See ALFRED F. CONARD, *CORPORATIONS IN PERSPECTIVE* 441-43 (1976) (“People organized in corporations have a somewhat different aspect than people acting individually, chiefly because the benefits and burdens and powers of decision are so dissipated among members of the group.”).

212 See, e.g., WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 109-10, 271-72 (5th ed. 1993). Klein and Coffee describe the corporation as “reified.”

That is, the law conceives of the corporation as having an existence separate from that of its employees, customers, suppliers, and so forth—but mainly, from its shareholders. Sometimes to be sure, the corporation is called a “fictional” entity—in apparent recognition of the abstract and potentially misleading nature of the concept. Still, there is the basic notion of a barrier, a psychological wall between the shareholders (and other participants in the venture) and the corporation.

*Id.* at 109-10. Felix Cohen observes:

Nobody has ever seen a corporation. What right have we to believe in corporations if we don't believe in angels? To be sure, some of us have seen corporate funds, corporate transactions, etc. (just as some of us have seen angelic deeds, angelic countenances, etc.). But this does not give us the right to hypostatize, to “thingify,” the corporation . . . .

Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 811 (1935).

213 Professor Hamilton describes the entity theory thus:

The nature of the fictitious entity that is a corporation is never precisely defined. A corporation can be envisioned as an artificial person having most of the same powers, rights, and duties that an individual has. This artificial person has no flesh, no blood, no eyes, or mouth but it may nevertheless do many things that real people do: it may sue and be sued, enter into contracts, purchase property, run a business, and so forth.

HAMILTON, *supra* note 52, at 313.

214 See DEL. CODE ANN. tit. 8, § 122 (1991); REVISED MODEL BUS. CORP. ACT § 3.02 (1984) (amended 1996).

215 Although many commentators vilify the concession theory for its failure to account for economic reality, see, e.g., William W. Bratton, Jr., *The “Nexus of Contracts” Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 434-36 (1989), the concession theory apparently remains persuasive to some, including the United States Supreme Court. See, e.g., *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987) (quoting with approval *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636 (1819) (defining corporation as “mere creature of law”)); cf. Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 188 (1991) (“The Anglo-American corporate form is a creation of the state, conceived originally as a privilege to be conferred on specified entities for the public good and welfare.”).

216 See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976) (“Contractual relations are the essence of the firm, not only with employees but with suppliers, customers,



In a classic statement of the nexus of contracts principle, Professors Jensen and Meckling describe the firm thus:

The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. . . . There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.<sup>217</sup>

This quote touches upon the ongoing debate between the “paternalist” versus “contractarian” theories in corporate<sup>218</sup> and partnership<sup>219</sup> law.

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creditors, etc. . . . It is important to recognize that most organizations are simply *legal fictions which serve as a nexus for a set of contracting relationships among individuals.*”) (footnotes omitted). A number of legal commentators have adopted variations on this theme. A leading example is Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) (“The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy.”). See also EASTERBROOK & FISCHEL, *supra* note 31, at 12 (“[W]e often speak of the corporation as a ‘nexus of contracts’ or a set of implicit and explicit contracts. This reference, too, is shorthand for the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves. The form of reference is a reminder that the corporation is a voluntary adventure, and that we must always examine the terms on which real people have agreed to participate.”).

<sup>217</sup> Jensen & Meckling, *supra* note 216, at 311 (emphasis and footnote omitted). In a footnote to this quote, Jensen and Meckling elaborate on the role of law in their theory of the firm as follows:

This view of the firm points up the important role which the legal system and the law play in social organizations, especially, the organization of economic activity. Statutory laws sets [sic] bounds on the kinds of contracts into which individuals and organizations may enter without risking criminal prosecution. The police powers of the state are available and used to enforce performance of contracts or to enforce the collection of damages for non-performance. The courts adjudicate conflicts between contracting parties and establish precedents which form the body of common law. All of these government activities affect both the kinds of contracts executed and the extent to which contracting is relied upon. This in turn determines the usefulness, productivity, profitability and viability of various forms of organization. Moreover, new laws as well as court decisions often can and do change the rights of contracting parties *ex post*, and they can and do serve as a vehicle for redistribution of wealth.

*Id.* at 311 n.14; see also MICHAEL J. TREBILCOCK, *THE LIMITS OF FREEDOM OF CONTRACT* 23-163, 188-240 (1993) (discussing policy modifications of contract law concerning “commodification,” “externalities,” “coercion,” “imperfect information,” “paternalism,” and “discrimination”). For a contractarian perspective of limited liability, see EASTERBROOK & FISCHEL, *supra* note 31, at 40-62 (describing limited liability as “a distinguishing feature of corporate law—perhaps *the* distinguishing feature”).

<sup>218</sup> See, e.g., Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1395-1415 (1989) (discussing contractual freedom in corporate law); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 2 (1990) (“Today, the clearest controversy is between the contractarians and anti-contractarians about the proper regard for freedom of contract in the corporation.”); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*,

What is the proper role, then, of business organization law? One answer posits that organizational law should reduce the cost of drafting a firm's contracts by providing a set of default rules that firms can adopt or reject at their option. Organizational law should provide mandatory rules, but only where doing so would reduce the adverse effects of externalities or imperfect information, and only where the cost of such intervention is less than the benefit.

In the contractarian paradigm,<sup>220</sup> organizational law aims to provide firms with a set of contract default rules that they can adopt or reject,<sup>221</sup> their content presumably mimicking the actual contracts that a majority of firms would adopt in the absence of transaction costs. Because the social value of default rules derives primarily from reduced transaction costs,<sup>222</sup> an "ideal" default rule would minimize contracting costs.<sup>223</sup> One scholar notes that if a default rule becomes less appealing than its drafters expected, or if the business environment changes so as to render the term obsolete, the social costs may be no greater than the transaction costs that firms incur in contracting around the default.<sup>224</sup>

A "tailored" default rule crafted in open-ended language enables courts to distinguish among firms in an attempt to mimic ex post the contract terms heterogeneous firms would have adopted in the absence of transaction costs.<sup>225</sup> Tailoring may enable default rules to promote optimal contractual terms while eschewing or eliminating suboptimal ones.<sup>226</sup>

1988 DUKE L.J. 879, 880 ("[D]escription drawn exclusively from contract principles are surely mistaken."); Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 277-83 (1986) (comparing contractual mechanisms in closely and publicly held corporations); Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291, 292-301 (1992) (discussing the Coasean Contractual Theory's application to the law of business associations).

219 See, e.g., Claire Moore Dickerson, *Is It Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111, 153 (1993) (arguing that the application of contractarian principles to partnerships is "inappropriate"); Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45, 52-82 (1993) (arguing that the Revised Uniform Partnership Act's drafters erred in attempting to specify all duties and that the Revised Uniform Partnership Act should only set forth basic rules, not a detailed contract for all partnerships); Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523 (1993) (discussing how the Revised Uniform Partnership Act "rejects the fiduciary world view of the common law and the [Uniform Partnership Act] for an essentially contractarian world view" and arguing such "contractarian error" should be eliminated from the statute).

220 See *supra* notes 36-49 and accompanying text (discussing basic premise of contractarian paradigm); see also *infra* notes 286-300 and accompanying text.

221 See EASTERBROOK & FISCHEL, *supra* note 31, at 34.

222 See David Charney, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1842 (1991).

223 See Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1403-08 (1992).

224 See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 826-27 (1995); see also David Charney, *supra* note 222, at 1841-42.

225 See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91, 117 (1989).

226 But see *id.* at 118 ("[T]ailored rules can actually exacerbate the inefficiency of strategic incompleteness.").

Business organization law's contractarian paradigm further provides a broad view of the nature of business contracting and the role of business organization law. This view adds a positive theory to the nexus of contract metaphor: In general there are no significant information imperfections affecting organizational contracting, and no third parties are adversely affected by the terms of the organizational contract. Consequently, contracts that maximize a firm's value maximize social wealth as well.<sup>227</sup> Any mandatory element of business organization law must be justified by a market failure<sup>228</sup>—an externality or an information imperfection—that severs the link between individuals' maximizing behavior and social optimality.<sup>229</sup>

This Part sets forth a proposal for unifying business organization law consistent with the goals of the contractarian perspective. Its focus is on the establishment of a framework for reform rather than the articulation of a detailed business organization code or model legislation. Accordingly, this Part considers first the possible basis for invoking double taxation upon business organizations, assuming that retaining some double taxation is inevitable. Second, and more fundamentally, this Part posits the structure of a new unified business organization law.

In sum, we propose that the law governing business organizations be reformulated so that there are precisely two distinct business organization codes: the TCC and the SBC. All entities that are organized under the TCC or are publicly traded would be subject to double taxation. All other entities would be presumed to elect pass-through taxation under the SBC but, nevertheless, may choose to opt into the double-tax system.

### *B. Clarifying the Role of Double Taxation*

Although full integration of the corporate and individual taxes may be much desired as a matter of policy, the revenue implications of such a change are politically prohibitive. Treasury has estimated that an imputation credit system would generate a fully phased-in revenue loss of \$14.6 billion per year.<sup>230</sup> Therefore, some form of continued double taxation appears inevitable.

Initially, businesses formed under TCC should continue to be taxed as corporations. The history of such taxation makes the traditional corporation a handy vehicle for delineating the application of double taxation. This bright line mechanism provides certainty in the choice of entity decision.

<sup>227</sup> For the classic statement of this view, see EASTERBROOK & FISCHER, *supra* note 31, at 1-39.

<sup>228</sup> For an overview of differences of view within the contractarian paradigm, see Bebchuk, *supra* note 218.

<sup>229</sup> See John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989).

<sup>230</sup> See TREASURY REPORT, *supra* note 70, at 152. This amount is a net revenue loss. Integration by the imputation credit system would result in revenue gains where corporate income is now taxed at less than the maximum corporate rate (the first \$75,000 of income). See I.R.C. § 11 (1994). The corporation's shareholders are in higher marginal tax brackets than the corporation's effective tax rate. See *id.* § 1, amended by SBJPA of 1996, Pub. L. No. 104-188, § 1704(m)(1), (2)(A)-(B), 110 Stat. 1755, 1882-83.

Beyond the traditional corporation, should other businesses be subject to the double tax? Recent history and some important policies also justify the conclusion that some other businesses, namely publicly traded enterprises, be taxed separately as well as corporations. Before turning to that category, however, we should address a categorization currently in use and often suggested that “large” businesses should be taxed differently than “small” businesses.

### 1. Large Versus Small

Professor Curtis Berger considers the distinction between large and small business entities as fundamental, suggesting that large entities should be subject to a two-tier tax applicable to corporations while small entities should be entitled to the pass-through treatment generally accorded to partnerships.<sup>231</sup> Size would be determined by the enterprise’s gross revenues such that all small businesses—whether organized in partnership or corporate form—would enjoy conduit treatment.<sup>232</sup> Entities would not be subject to two-level tax until their gross revenues exceeded an unspecified threshold.<sup>233</sup>

Another alternative method for distinguishing between single-tax entities and double-tax entities is the number of owners. This factor is one of the most important features used in Subchapter S of the Code to distinguish single-tax S corporations from double-tax C corporations.<sup>234</sup> When the Treasury originally established the limit of ten S corporation shareholders in 1958,<sup>235</sup> the design was intended for small businesses, and simplicity was an important goal.<sup>236</sup> Limiting the number of shareholders achieved administrative simplicity because the corporation’s treatment of items of income or deduction—and Service auditing of that treatment—could affect no more than ten tax returns.<sup>237</sup> To some extent, amendments to the statute to allow additional shareholders, ultimately up to thirty-five under the 1982 amendment,<sup>238</sup> compromised that simplicity.

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<sup>231</sup> See Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 106-07 (1992). Thus, large business entities, whether they are structured as corporations or partnerships, would be subject to the two-level tax. See *id.*

<sup>232</sup> See *id.* at 106-07.

<sup>233</sup> See *id.* at 107. The two-level tax would apply only if the entity’s gross revenues remained at a determined level for several years. See *id.* The shortcomings of this approach have been identified by Professor Jerome Kurtz in connection with his alternative classification proposal. See Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger’s Plan*, 47 TAX L. REV. 815, 816-18, 826-32 (1992).

<sup>234</sup> See I.R.C. § 1361(b)(1)(A) (limiting the number of shareholders in an S corporation to 35), amended by SBJPA of 1996 § 1301, 110 Stat. at 1777. Under S corporation eligibility, the shareholders must be individuals who are not nonresident aliens. See *id.* § 1361(b)(1)(C).

<sup>235</sup> See Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64(a), 72 Stat. 1606, 1650 (1958).

<sup>236</sup> See JAMES S. EUSTICE & JOEL D. KUNTZ, *FEDERAL INCOME TAXATION OF S CORPORATIONS* ¶ 1.03[2][b] (3d ed. 1993).

<sup>237</sup> See *id.*

<sup>238</sup> See Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 1361(b)(1)(A), 96 Stat. 1669, 1669 (codified at 26 U.S.C. § 1361).

Nevertheless, a limitation based on the number of owners does provide a clear dividing line—although circumvention is possible by stacking entities—in Subchapter S. The possibility of manipulation of the number of shareholders in the S corporation context is precluded by requiring that only individuals—and certain trusts and estates<sup>239</sup>—can be shareholders.<sup>240</sup> A similar requirement could be imposed on SBOs. Alternatively, SBO ownership could be limited to a fixed number of non-pass-through owners such as individuals and C corporations. Under this rule, the number of taxpayers whose tax liabilities could be affected by the SBO's taxable income would be limited to the fixed number, which is one of the principal goals of setting a maximum number of permissible owners.

## 2. Public Versus Private

In addition to the separately taxed traditional corporations, we believe that the decision to accord conduit versus dual-level taxation should hinge on the distinction between publicly traded entities and private entities: publicly traded entities would be subject to a two-tier tax, but privately held entities in other forms would only be subject to a one-tier tax.<sup>241</sup> The Code already makes this public/private distinction,<sup>242</sup> which appears to be functioning reasonably well.<sup>243</sup>

Focusing on the public/private distinction allows tax-free implications with appreciated property in situations in which the transferor has not essentially changed economic position.<sup>244</sup> When a transferor of property receives publicly traded securities, "the transferor has experienced a significant change of position."<sup>245</sup> Moreover, a public/private dichotomy may lessen the necessity of distinguishing interest and compensation from dividends.<sup>246</sup>

On a practical level, allocating income among numerous entity owners who frequently transfer their securities on the open market is nearly impossible with publicly traded companies; conduit treatment for nonpublicly traded

<sup>239</sup> See I.R.C. § 1361(b)(1)(B), (c)(2), (c)(3), (d) (1994), amended by SBJPA of 1996 §§ 1316(a)(1), 1302(a)-(b), 110 Stat. at 1785-86, 1777.

<sup>240</sup> See *id.* § 1361(b)(1), amended by SBJPA of 1996 §§ 1301, 1316(a)(1), 110 Stat. at 1777, 1785-86. S corporations, however, can be partners in a larger corporation.

<sup>241</sup> See Kurtz, *supra* note 233, at 824-26.

<sup>242</sup> See I.R.C. § 7704 ("[E]xcept as provided . . . a publicly traded partnership shall be treated as a corporation.").

<sup>243</sup> See Kurtz, *supra* note 233, at 824-26.

<sup>244</sup> See *id.* at 824. Kurtz explains:

The public/private distinction seems more appropriate . . . when the issue is the tax implications of transactions between the entity and an owner of the entity. One exchanging property for marketable securities quite clearly has experienced a significant change of position, and the imposition of a tax on the transaction seems appropriate. The change of position is usually less obvious where the exchange is of property for an interest in a non-publicly traded partnership . . . [If there is no public/private distinction] all contributions of property to a small entity would be tax-free, even if the entity is publicly traded and always taxable, even if to a closely held partnership, as long as it were large.

*Id.*

<sup>245</sup> Goldberg, *supra* note 50, at 1008.

<sup>246</sup> See Kurtz, *supra* note 233, at 824-25.

entities, however, poses few administrative burdens.<sup>247</sup> Distinguishing between public and private entities may also facilitate a transition to an integrated tax system whereupon publicly traded entities can accomplish integration through an imputation credit system.<sup>248</sup>

### C. *The Structure of the Proposed Legislation: Introducing the SBO*

While the traditional corporation offers a ready-made organizational structure, the law establishing a noncorporate business alternative should be flexible and enable entrepreneurs to implement a variety of relationships and structures in arranging their economic affairs.<sup>249</sup> Such a law should remove unnecessary operational and contractual restrictions while answering the basic needs of business through the creation of default rules promoting efficiency consistent with likely business expectations. Most fundamentally, the law should reflect the typical expectations of business participants with respect to the basic attributes of the entity.

With these goals in mind, the fundamental attributes of such a law, our proposed SBC, as set forth in Part III.C.1, are fairly clear: (1) limited liability; (2) free transferability of interests; (3) continuity of life; (4) pass-through taxation; and (5) inherent flexibility. Less clear is the desirability of centralized management; we propose a framework of presumed owner management that allows the owners maximum flexibility and freedom of contract.

The basic organizational and operational framework of an organization formed under the SBC, the SBO, is reflected in two essential documents. First, mirroring the Articles of Incorporation for TCOs, the basic parameters of governance and owners' rights will be set forth in the SBO's Articles of Organization. Second, as an analogue to the traditional corporate "bylaws" and "shareholder control agreements," we propose a comprehensive SBO "Owner Control Agreement." As discussed in Part III.C.2, this Owner Con-

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<sup>247</sup> See *id.* at 825.

<sup>248</sup> See *id.* at 825-26. Under an imputation credit system, the corporate tax is viewed as a withholding tax on shareholders' income. When the corporation makes an actual or constructive distribution of income, the shareholders are treated as receiving both the distributed earnings and the corporate tax paid on those earnings. See *id.*

<sup>249</sup> This is not to say that there is not room for improvement, however, the preferable improvements are those aimed at preserving the essential scheme of treating the partnership as an aggregate of its members rather than as a separate entity. Thus, desirable changes are those designed to carry out that scheme more effectively and to prevent abuses. For example, Professor Andrews suggests that the basis adjustment rules under Code § 734(b) be made mandatory. See William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3, 23 (1991). Making the Code § 734(b) rules mandatory would prevent abuses that can occur when appreciated property is distributed to a partner without immediate recognition of gain at a time when there is no Code § 754 election in place. See *id.* at 23-24; see also FEDERAL INCOME TAX PROJECT, AMERICAN LAW INST., SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS 5-9 (1984) (adopting the pass-through approach as the model for taxing partnership earnings); Noel B. Cunningham, *Needed Reform: Tending the Sick Rose*, 47 TAX L. REV. 77, 104 (1991) (advocating and endorsing Professor Andrew's proposals relating to partnership distributions); John P. Steines, Jr., *Unneeded Reform*, 47 TAX L. REV. 239, 245 (1991) (questioning the need for reform of Subchapter K in the light of the fact that many perceived abuses are addressed by recent expansion of Code § 704(c)(1)(B) to contributing partner redemptions).

trol Agreement would set forth the basic contract between the owners and the SBO. Typically, the Owner Control Agreement will include, among other provisions, various owner protection devices, buy/sell provisions, confidentiality clauses, and agreements to arbitrate disputes.

## 1. The SBC

### a. Limited Liability

As stressed previously, limited liability is a *sine qua non* for optimal business organization law;<sup>250</sup> accordingly, the SBC would create limited liability through the same mechanisms and to the same extent as traditional corporations. The SBC would once and for all completely sever the link between limited liability and double taxation. The limited liability/double-tax dilemma that has dominated business organization law up until now as an archaic, inefficient, and ill-conceived tradeoff would cease to exist. Goodbye forever.

Limited liability will attach as soon as the SBO Articles of Organization are filed with the appropriate state authority. Just as with corporations, absent a personal guaranty to the contrary, no owner shall be subject to personal liability beyond her financial investment in the SBO. Such limited liability may be subject to veil-piercing that initially will parallel current corporate veil-piercing rules, but may evolve into a unique set of common law principles. Time will tell.

### b. Free Transferability of Interests

[A corporation is] a person that never dies: in like manner as the river Thames is still the same river, though the parts which compose it are changing every instant.<sup>251</sup>

According to the traditional corporate norm, owners have the power to transfer or to retain their ownership interests—shares—without interference by the other owners or the corporation. This is the essence of the characteristic of free transferability of interests. Likewise, the SBC would not restrict transferability and SBOs would possess free transferability of interests. Business owners will have the ability to modify or transfer their interests at will without being concerned about the potential negative tax impact of that freedom.

To be sure, however, voluntary restrictions on transferability would be allowed, and often imposed, in the small business organization. Yet the nature and extent of those restrictions would not be dictated or presumed, but rather negotiated, thereby maximizing the freedom and choice of the business participants. Specifically, the optimal restrictions on transferability for any given SBO will be articulated in its Owner Control Agreement.

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<sup>250</sup> See *supra* notes 11-49 and accompanying text.

<sup>251</sup> 1 WILLIAM BLACKSTONE, COMMENTARIES \*468.

c. *Continuity of Life*

[With continuity of life], a perpetual succession of individuals are capable of acting for the promotion of the particular object, like one immortal being.<sup>252</sup>

The SBC would designate an SBO as an independent legal entity, separate and distinct from its owners, and unaffected by changes in the identity of the parties owning its shares. Thus, the SBO would possess continuity of life. Business owners expect a business to continue operating despite the withdrawal of one of the original participants. Goodwill and good business justify the assumption of continuity of existence for the SBO, subject, as always, to owner determination otherwise.<sup>253</sup>

In the event that an SBO intends to have a limited existence, such must be set forth in the Articles of Organization or in the Owner Control Agreement. In any case, such election shall have no impact upon the SBO's tax status.

d. *Presumed Owner Management*

Corporate law invests the board of directors with the power to manage the affairs of corporations. Because a centralized board and not the individual owners manage the corporation, centralized management exists. This premise will continue for TCOs governed by TCCs.

However, we reverse the presumption under the SBC for SBOs: the SBO would have presumptive owner management. Those investing their money in a business generally expect to take an active voice in its affairs. They should be presumed to be involved in the ongoing operations of the business, but have the flexibility to alter that presumption without jeopardizing the SBO's tax status.

An entity run by managers who are elected by the owners, such as the traditional corporation, on the other hand, generally will possess centralized management.<sup>254</sup> Many organization participants may desire centralized management for nontax reasons, because—agency costs aside—it may allow for more efficient management of the business.

Presuming an owner-managed firm, however, does not restrict the available management structures.<sup>255</sup> Under some circumstances, an owner-managed organization may require a manager who is also an owner.<sup>256</sup> The

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<sup>252</sup> Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819) (Marshall, C.J.).

<sup>253</sup> Under current Treasury regulations, however, an organization which has continuity of life faces increased risk of double taxation. This linkage is once again unfortunate. The flaw in these machinations is that a continuity of life characteristic analysis should not be considered in a tax analysis at all. Once again the current regulations highlight the frailty of this linkage. See Treas. Reg. § 301.7701-2(a) (1995).

<sup>254</sup> See *id.* § 301.7701-2(c).

<sup>255</sup> See Rev. Proc. 95-10, § 5.03(1), 1995-1 C.B. 501, 504.

<sup>256</sup> See *id.* This could occur under the Treasury's regulations and Service ruling guidelines if the member-managers in the aggregate own at least 20% of the total interests in the LLC so that, in theory, they are regarded as looking after their own interests when they manage the



owners can also provide that an SBO has centralized management by designating a person—or any group of persons that does not include all of the owners—with continuing exclusive or nonexclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed.<sup>257</sup> In an organization with more than a few owners, the owners may want to isolate management authority in one or more owners.

Management structure, then, should be a function of choice rather than an attempt to avoid unfavorable tax classification. By providing the presumption of owner management in the SBO and allowing maximum flexibility to change without affecting tax status, an optimal result is achieved.

## 2. *The New Role for Owner Control Agreements*

A key aspect to our proposal is the central role of the Owner Control Agreement, as adopted by the owners of the SBO. Given the presumed owner management of the SBO, Owner Control Agreements will emerge as the operational “Bible” of SBOs. In effect, the Owner Control Agreement enables the owners of each SBO to self-tailor their own business organization law, together with all fiduciary duties and remedies the owners deem appropriate. Although this will impose drafting burdens upon the SBO at its initial formation, it will also force the parties to think through their relationship with each other and with the SBO.

We envision that Owner Control Agreements will parallel partnership agreements in their ability to retain the potential for custom tailoring and designing the SBO with much of the imaginative freedom that contracting parties under our legal system generally enjoy. Although the Owner Control Agreement, like other contracts, must be agreed to by all of the owners—and generally can be amended only with unanimous consent of the owners—it may set forth various self-tailored procedural rules requiring simple majority vote (e.g., majority approval of certain implicated transactions) or some level of supermajority vote (e.g., ratification of conflict transactions through two-thirds owner approval).

Declaring in 1992 that “[i]t is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements,”<sup>258</sup> Delaware enacted this compelling provision that has been followed by several other states.<sup>259</sup> Other subsequent statutes are based on the *ABA Prototype Limited Liability Company Act* (“*ABA Prototype Act*”).<sup>260</sup>

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company rather than representing others' interests. See Treas. Reg. § 301.7704-2(c)(4) (relating to limited partnerships); Rev. Proc. 95-10, § 5.03(2), 1995-1 C.B. 501, 504.

<sup>257</sup> See Treas. Reg. § 301.7701-2(c).

<sup>258</sup> DEL. CODE ANN. tit. 6, § 18-1101(b) (1993).

<sup>259</sup> See, e.g., CONN. GEN. STAT. ANN. § 34-242 (West Supp. 1996); N.J. STAT. ANN. § 42:2B-66(a) (West Supp. 1996); N.M. STAT. ANN. § 53-19-65(A) (Michie Supp. 1993); WASH. REV. CODE ANN. § 25.15.800(2) (West Supp. 1996).

<sup>260</sup> WORKING GROUP ON THE PROTOTYPE LTD. LIAB. CO. ACT ET AL., AMERICAN BAR ASS'N, PROTOTYPE LIMITED LIABILITY COMPANY ACT, reprinted in 1 STATE LIMITED LIABILITY COMPANY & PARTNERSHIP LAWS PLLCA-1, PLLCA-1 to -139 (Michael A. Bamberger & Ar-

Although LLC statutes embody several different approaches as to fiduciary standards of conduct, many states, including Delaware, do not contain any standards and simply enable parties to articulate codes of conduct in their operating agreement.<sup>261</sup> Specifically, the Delaware LLC statute empowers the owners to tailor their own standards of owner conduct<sup>262</sup> and the specification of penalties for the violation of those standards.<sup>263</sup> Other states prescribe a minimal standard of gross negligence and empower the parties to change the standard by express agreement.<sup>264</sup> In accordance with Delaware precedent, we propose to leave this issue to the owners and the common law of agency.

The *ABA Prototype Act* follows the “default rule” model, establishing a minimal level of fiduciary duties that can be altered by an express operating agreement.<sup>265</sup> The default rule in the *ABA Prototype Act* does not include member-to-member fiduciary duties directed to the oppression of minority members.<sup>266</sup> Statutes patterned after the *ABA Prototype Act* are similar.<sup>267</sup> Likewise, the Owner Control Agreements for SBOs would be free to adopt member-to-member fiduciary duties.

#### IV. *The Impact of an SBO Regime*

Once shorn of the shackles of the Service classification rules which exalt form over substance, states can pursue two distinct pathways. First, state legislatures can, at long last, enact substance-driven SBCs designed to maximize economic efficiency, promote fairness, protect owners, and enhance flexibility. Second, states can continue their “race-to-the-top”—or “race-to-the-bot-

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thur J. Jacobson eds., Supp. 1994) [hereinafter ABA PROTOTYPE ACT]. The Act is the model for several jurisdictions. See, e.g., ARK. CODE ANN. § 4-32-1304(a)-(b) (Michie Supp. 1996); GA. CODE ANN. § 14-11-1107(a)-(b) (1994).

<sup>261</sup> See DEL. CODE ANN. tit. 6, § 18-306; N.J. STAT. ANN. § 42:2B-30 (West Supp. 1996).

<sup>262</sup> See DEL. CODE ANN. tit. 6, § 18-306 (remedies for breach of LLC agreement by member).

<sup>263</sup> See *id.* § 18-405 (remedies for breach of LLC agreement by manager).

<sup>264</sup> See, e.g., ARK. CODE ANN. §§ 4-32-402, -404; CAL. CORP. CODE § 17005(d) (West Supp. 1995); IDAHO CODE §§ 53-622, -624 (1994). Some of the newest statutes have ratcheted the default standard up to “wanton or reckless misconduct.” E.g., KY. REV. STAT. ANN. § 275.170(1) (Michie Supp. 1994). Colorado’s 1994 revisions require that managers act in accordance with a core of nonwaivable duties but allow an agreement to determine standards “by which the performance of the [good faith] obligation is to be measured, if such standards are not manifestly unreasonable . . .” COLO. REV. STAT. § 7-80-108(2)(c) (Supp. 1995).

<sup>265</sup> See ABA PROTOTYPE ACT, *supra* note 260, § 402. The default duties are gross negligence or willful misconduct and accounting for personal benefits from use of company assets or information without the consent of the company. See *id.*

<sup>266</sup> The *ABA Prototype Act*’s due care language provides for culpability in cases of “gross negligence or willful misconduct.” *Id.* § 402(A). The duty of loyalty default standard in the *ABA Prototype Act* focuses on an improper benefit received “without the consent of more than one half by number of the disinterested managers or members” from “any transaction” with the company or the use of company property. *Id.* § 402(B).

<sup>267</sup> See, e.g., ARK. CODE ANN. § 4-32-402 (duties of managers and members); *id.* § 4-32-404 (limitation of liability and indemnification of members and managers); *id.* § 4-32-1310(a) (evidentiary effect of copy of filed document); IDAHO CODE § 53-622 (duties of managers and members); *id.* § 53-624 (limitation of liability and indemnification of members and managers); *id.* § 53-668(1) (rules of construction).

tom,” as the case may be—by enacting TCCs designed to satisfy interest groups active within that state.

For SBOs, the substantive law should be dictated by the owners—by the parties to the Owner Control Agreements. Those parties are best suited to negotiate an Owner Control Agreement self-tailored to their particular requirements. Perhaps the role of SBCs is to provide “menus” into which owners can elect inclusion in their Owner Control Agreements.<sup>268</sup> In this case, we would expect a commission on uniform state laws to promulgate a uniform set of “menus” to be incorporated into Owner Control Agreements at the option of the negotiating owners.

Once states accede that the substantive law for SBOs must be left up to the owners—and other parties to the Owner Control Agreement—such that states are not mandating particular substantive terms to govern SBOs, the resulting SBCs will focus on minimal procedural parameters. In focusing on minimal procedural parameters in their SBCs, states will come to realize that an optimal regime embodies no more than the SBO characteristics discussed in the previous section together with basic procedural requirements that ensure fundamental fairness and protection of essential property rights.

In essence, the SBC will become a uniform statute that allows the parties to particularize, through negotiation, the substantive terms of their relationship to one another. Meanwhile, the TCC will continue to cater to that state’s special interest groups, and the resultant corporate governance provisions (e.g., voting and inspection rights) will vary from state to state depending upon the nature and strength of the disparate lobbying efforts within each state.

Thus, as to SBOs, the race to the top/bottom is irrelevant; as to TCCs, the race is on as usual. The ultimate question, of course, is the impact of the SBO regime upon both the destiny of business organization law and the fair and efficient functioning of society.

#### A. *Enhanced Economic Efficiency and Reduced Agency Costs*

The key feature of the . . . corporation is Adolph [sic] Berle and Gardiner Means’s insight concerning the separation of ownership and control: managers of the firm, who run the business, are not the owners.<sup>269</sup>

Large publicly traded corporations are handcuffed to a centralized management regime. With thousands of passive shareholders scattered throughout the globe, seldom will a shareholder seek to actively participate in the management of the corporation—thus, the ineluctable need for centralized management. Many smaller business entities, however, view centralized management from a different lens: owners want to manage and managers want to own. Absent a union of incentives, rewards, commitment, effort, and entrepreneurial creativity, economic efficiency may flounder. A regime of

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<sup>268</sup> See, e.g., Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 372 (1995) (encouraging the adoption of free business forms that would possibly include “all-purpose statutory business association ‘menus’”).

<sup>269</sup> ROBERTA ROMANO, *FOUNDATIONS OF CORPORATE LAW* at v (1993).

centralized management may militate against this synergy of ownership and control and tend to ill-serve privately held business organizations.

Economic policy plays a central role in the development of business organization law.<sup>270</sup> Most wealth in corporate form is held by large, publicly traded corporations.<sup>271</sup> In these corporations, ownership is separated from control. The firms are controlled by professional managers, while firm owners—the shareholders—are largely passive.<sup>272</sup> Although managers are entrusted with guarding shareholder interests, their own interests do not always coincide with those of shareholders. Where the interests of these two groups conflict, managers typically pursue their own interests, even at shareholders' expense.<sup>273</sup>

Much of the conflict between shareholders and managers arises from their divergent portfolios. Most shareholders hold fully diversified portfolios; managers dedicate most of their wealth in their corporate employer, largely in the form of firm-specific human capital. These different portfolios produce different attitudes towards the risk of firm failure.<sup>274</sup> Shareholders holding fully diversified portfolios are effectively risk-neutral;<sup>275</sup> managers dependent on the fortunes of their firm are risk-averse.<sup>276</sup>

270 See EASTERBROOK & FISCHER, *supra* note 31, at 40-41; see also RICHARD A. POSNER, *ECONOMIC ANALYSIS OF THE LAW* 391-97 (3d ed. 1986) (describing the corporation in economic terms).

271 See MATHESON, *supra* note 2, § 1:02 (noting that the 500 largest publicly traded corporations control roughly 40% of the total domestic wealth).

272 See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 7-9 (1933); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 *STAN. L. REV.* 819, 833-36 (1981); see also Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 *UCLA L. REV.* 811, 815-20 (1992) (analyzing institutional investor monitoring and stressing that "corporate managers need to be watched by someone"); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 *MICH. L. REV.* 520, 521-22 (1990) (examining the nature and extent of shareholder passivity but arguing that passivity is not inevitable).

273 See, e.g., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 *J. POL. ECON.* 288, 288-90 (1980) (noting the "incentive problems" arising when decisions are left to managers that are not also owners); Jensen & Meckling, *supra* note 216, at 305 (discussing the effects of separating ownership from control).

274 See Jensen & Meckling, *supra* note 216, at 349-50, 352-53; Alan J. Marcus, *Risk Sharing and the Theory of the Firm*, 13 *BELL J. ECON.* 369, 369-70 (1982); Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 *J. LEGAL STUD.* 277, 277-79 (1991). See generally Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 *BELL J. ECON.* 55, 55-57 (1979) (describing the risk allocation implicit in principal-agent payment arrangements).

275 Accordingly, owners generally desire managers to maximize each firm's expected profits without regard to risk. *But see* Jonathan R. Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 *B.U. L. REV.* 315, 326 (1991) (noting that "[w]hile managers' efforts to avoid bankruptcy by taking huge risks may benefit shareholders, often they do not").

276 See RONALD W. MASULIS, *THE DEBT/EQUITY CHOICE* 47-60 (1988) (describing potential conflicts of interest between stockholders and risk-averse managers); Jensen & Meckling, *supra* note 216, at 306, 308-10 (discussing why "the agent will not always act in the best interests of the principal"). For an empirical analysis, see Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis*, 48 *J. FIN.* 425, 440-48 (1993); Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 *U. PA. L. REV.* 125, 149-50 (1990); see also William J. Carney, *Controlling Management Opportunism in the Market for Cor-*

Accordingly, risk-averse managers will sometimes pursue different investments than risk-neutral shareholders would choose. Shareholders generally want the firm to pursue any project, however risky, that has positive expected profits; managers, by contrast, may avoid some high-risk projects, even though these projects have positive expected profits.<sup>277</sup> In addition, managers may attempt to reduce the risk of firm failure by diversifying the firm—e.g., by expanding the firm into new businesses that face independent risks—even when such diversification results in a reduction in firm value.<sup>278</sup> This reduction in firm value is borne by the shareholders, who generally derive no independent benefit from the diversification of any one firm because they already own diversified portfolios.<sup>279</sup>

Portfolio differences may produce another conflict between shareholders and managers. Managers may pursue investment strategies not designed to maximize profits but to secure their positions and increase their salaries.<sup>280</sup> Managers may, for example, increase their value to the firm through irreversible investments in their areas of expertise<sup>281</sup> or may attempt to preserve

*porate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385, 418-20 (suggesting that managers' limited marketability may cause them to overreact when control of the firm is in question); Rose-Ackerman, *supra* note 274, at 279-97 (arguing that managers fear loss of both job and prestige if firm encounters financial difficulties).

<sup>277</sup> See David Hirshleifer & Anjan V. Thakor, *Managerial Conservatism, Project Choice, and Debt*, 5 REV. FIN. STUD. 437, 437-39, 465 (1992) (noting that managers' concern for their reputations may exacerbate their tendency to pursue overly safe projects); Anjan V. Thakor, *Corporate Investments and Finance*, 22 J. FIN. MGMT. ASS'N 135, 139-40 (1993) (discussing how managers' incentive to "build their own reputations distorts firms' investment policies in favor of relatively safe projects"); see also David Hirshleifer, *Managerial Reputation and Corporate Investment Decisions*, 22 J. FIN. MGMT. ASS'N 145, 145-46 (1993) (describing reasons for, and effects of, managers' decision to build personal reputations). See generally BERLE & MEANS, *supra* note 272, at 119-25 (addressing how the interests of control and ownership diverge in the modern corporation); ADAM SMITH, *THE WEALTH OF NATIONS* 699-700 (Edwin Cannon ed., 1937) (suggesting that managers negligently operate corporations because they do not share the interests of the owners); Jensen & Meckling, *supra* note 216, at 306, 308-10 (noting that in most agency relationships there are costs associated with the divergence of the proprietor's and agent's interests).

<sup>278</sup> See, e.g., Randall Morck et al., *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31, 31-32 (1990); Andrei Shleifer & Robert W. Vishny, *Value Maximization and the Acquisition Process*, 2 J. ECON. PERSP. 7, 13-15 (1988); see also Larry H.P. Lang & Rene M. Stulz, *Tobin's q Corporate Diversification, and Firm Performance*, 102 J. POL. ECON. 1248, 1248 (1994) (arguing there is no evidence that diversified firms are poor performers when compared to firms that are not diversified).

<sup>279</sup> Indeed, shareholders of firms pursuing activities with substantial potential tort liability may prefer to organize these activities into separate corporations in order to gain maximum benefit from limited liability.

<sup>280</sup> In addition, managers may want to spend more on perquisites and other benefits than shareholders would prefer. See Jensen & Meckling, *supra* note 216, at 308-10.

<sup>281</sup> See Andrei Shleifer & Robert W. Vishny, *Management Entrenchment: The Case of Manager-Specific Investments*, 25 J. FIN. ECON. 123, 123-24, 137 (1989); see also NANCY L. ROSE & ANDREA SHEPARD, *FIRM DIVERSIFICATION AND CEO COMPENSATION: MANAGERIAL ABILITY OR EXECUTIVE ENTRENCHMENT?* 1-6, 18-33 (National Bureau of Econ. Research Working Paper No. 4723, 1984) (suggesting that managing a diversified firm requires special managerial talent, therefore, managers with this particular talent may have an incentive to diversify their firms in order to maximize their value to the firm).

their positions by expanding the firm into new businesses, even though shareholder wealth maximization might dictate shrinkage or liquidation.

As a response to the increasing practical complexity of business decisionmaking, centralized management has emerged as a virtual necessity for large firms.<sup>282</sup> Alfred Chandler has demonstrated how the corporate organizational transformation developed efficiencies of scale and scope that helped to spark a phenomenal period of economic growth in the twentieth century.<sup>283</sup> Hierarchical business organizations may reduce transaction costs when it is less costly to provide goods or services internally rather than through market purchases or sales.<sup>284</sup> Central management may enhance efficiency by enabling managerial divisions of labor, through specialized educational training of future managers and differentiation of managerial occupations within businesses.<sup>285</sup>

It is clear, however, that centralized management is best chosen as a structural alternative, not mandated in substance or in form. The SBO presumes owner management and thereby minimizes the agency costs associated with the separation of ownership and control. Any deviation from this presumption requires a balancing of the benefits with the problems of incentives and control. The owners of a business are best able to weigh these considerations and make their own choices on the relevant tradeoffs.

<sup>282</sup> See ALFRED D. CHANDLER, JR., *SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM* 17 (1990) (describing economies of scale as "those that result when the increased size of a single operating unit producing or distributing a single product reduces the unit cost of production or distribution"). Economies of scope are "economies of joint production or distribution" that result "from the use of processes within a single operating unit to produce or distribute more than one product." *Id.*

<sup>283</sup> Chandler describes this economic efficiency of centralized management:

Transaction costs are those involved in the transfer of goods and services from one operating unit to another. When these transactions are carried out between firms or between individuals, they usually involve the transfer of property rights and are defined in contractual terms. When they are carried out within the enterprise, they are defined by accounting procedures. The costs of such transactions are reduced by a more efficient exchange of goods and services *between* units, whereas the economies of scale and scope are closely tied to the more efficient use of facilities and skills *within* such units.

*Id.* (internal footnote omitted); see OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 15-42, 68-84 (1985) (discussing transaction cost economics and the governance of contractual relations).

<sup>284</sup> See CHANDLER, JR., *supra* note 282, at 8-9.

<sup>285</sup> Professor Chayes summarizes the economic objective thus:

The corporation is necessary because the objects pursued are beyond the reach of the members as individuals. The needed amounts of capital are too great, the risk is too high, the duration of the enterprise too long. The corporation is the legal institution which can hold the aggregated capital of many over a period of time unaffected by the death or withdrawal of individuals.

Abram Chayes, *The Modern Corporation and the Rule of Law*, in *THE CORPORATION IN MODERN SOCIETY* 25, 34 (Edward S. Mason ed., 1960).

## B. Contractual Freedom and Flexibility

A contractarian model<sup>286</sup> dominates business organization law scholarship,<sup>287</sup> positing that the firm embodies a “nexus of contracts”<sup>288</sup> or a collection of consensual relationships among shareholders, creditors, managers, and perhaps other persons with vested interests. Some “contracts” are explicit, some implicit, and some provided by law. These contracts define the rights and obligations of the firm’s constituents, and they derive from a market-mediated process that tends to lead the constituents of the firm to adopt contract terms that maximize the firm’s value. In the context of publicly traded corporations, the pricing mechanism of the securities market, together with a variety of managerial incentives designed to maximize share values, compels corporate managers to adopt terms that minimize agency costs and thus maximize firm value.<sup>289</sup>

Although the “nexus of contracts” theory remains persuasive for some, other leading legal scholars discount the theory.<sup>290</sup> Dean Robert Clark demonstrates that a corporation cannot be considered a nexus of actual legal contracts, and that metaphorical thinking about “implicit or standardized” contracts is “troublesome” and “treacherous.”<sup>291</sup> Other scholars argue that contractarian theories of the corporation fail to account for many “mandatory rules” of organizational law.<sup>292</sup> These theories also fail to recon-

<sup>286</sup> For a discussion of the contractarian model, see *supra* notes 36-49 and accompanying text.

<sup>287</sup> Dean Robert Clark has characterized the contractarian perspective as “dominat[ing] the thinking of most economists and most economically oriented corporate law scholars who focus at all on the theory of the corporation.” Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1705 (1989).

<sup>288</sup> Professors Jensen and Meckling coined the term “nexus for contracting relationships.” Jensen & Meckling, *supra* note 216, at 311.

<sup>289</sup> For scholarship on the contractarian perspective in the economics literature, see Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Jensen & Meckling, *supra* note 216; Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984).

<sup>290</sup> See, e.g., Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1404 (1985) (arguing that the contract theory improperly legitimizes “substantially unaccountable managerial discretion to determine corporate activities and to serve itself at the expense of investors”); Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (John W. Pratt & Richard J. Zeckhauser eds., 1991); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 972 (1988) (proposing a modification of the contract theory in which corporations may opt out and choose “among quality-controlled alternatives”); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1449 (1989) (arguing that the contract metaphor suffers from ambiguity that limits its usefulness and suggesting a partial return to the metaphor of trust).

<sup>291</sup> ROBERT C. CLARK, *CORPORATE LAW* 59-71 (1986); see also Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697, 698 (1990) (noting “the fact that contractarian theorists to some extent use the idea of contract metaphorically” is troublesome).

<sup>292</sup> See, e.g., Eisenberg, *supra* note 36, at 1486 (noting that if corporations were merely a “nexus of contracts” they would be free to vary the terms rather than be bound by mandatory rules); Gordon, *supra* note 41, at 1553 (arguing that although much of corporate law allows

cile the central role of courts in enforcing contracts allowed by “enabling rules.”<sup>293</sup> Further, Clark and others disagree that one can properly consider managers and directors of a corporation as legal “agents” of shareholders.<sup>294</sup>

In the contractarian paradigm, firm managers select contract terms that capital markets price and that investors purchase when they purchase a firm’s securities.<sup>295</sup> Judge Frank Easterbrook and Professor Daniel Fischel state that “corporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting. . . . Corporate codes and existing judicial decisions supply these terms ‘for free’ to every corporation, enabling the venturers to concentrate on matters that are specific to their undertaking.”<sup>296</sup> Accordingly, socially optimal organizational law would provide a set of “default” terms, any or all of which a firm could adopt by inaction or reject by explicitly customizing an alternative term. Such default terms should parallel or mirror the terms that firms would select in the absence of transaction costs.<sup>297</sup> Generally, an efficient default rule is one that minimizes the aggregate cost of contracting.<sup>298</sup>

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parties to contract freely and “opt out” of certain standard terms, many features of corporate law remain mandatory). *But see, e.g.,* Romano, *supra* note 41, at 1599, 1616 (arguing that many “mandatory” rules may be avoided, although admitting that some mandatory rules are desirable “when externalities are present”).

<sup>293</sup> *See, e.g.,* Coffee, Jr., *supra* note 229 (analyzing the judicial role in corporate law and discretionary judicial response to default rules).

<sup>294</sup> Dean Robert Clark argues:

A review of elementary corporate law shows that [the] power of the principal to direct the activities of the agent does not apply to the stockholders as against the directors or officers of their corporation. By statute in every state, the board of directors of a corporation has the power and duty to manage or supervise its business. The stockholders do not. To appreciate the point fully, consider the following activities: setting the ultimate goal of the corporation—for example, whether its legal purpose will be to maximize profits; choosing the corporation’s line of business—for example, whether it will engage in retailing general merchandise or refining oil; hiring and firing the full-time executives who will actually run the company; and exercising supervisory power with respect to the day-to-day operations of the business. Stockholders of a large scale corporation do not do these things; as a matter of efficient operation of a large firm with numerous residual claimants they should not do them; and under the typical corporate statute and case law they cannot do them.

CLARK, *supra* note 291, at 56-57.

<sup>295</sup> Those terms might define shareholder voting rights, managers’ duties of care and loyalty, shareholders’ rights to dividends, or other aspects of the relationships among shareholders and managers. *See, e.g.,* EASTERBROOK & FISCHEL, *supra* note 31, at 1-4 (noting that managers arguably attempt to offer terms that maximize share values by minimizing agency costs and signaling to investors valuable information about the firm).

<sup>296</sup> *Id.* at 34.

<sup>297</sup> *See id.* at 34-35. Some scholars suggest that default rules may be designed to penalize parties that fail to adopt certain explicit contract terms. *See* Ayres & Gertner, *supra* note 225, at 92-95; Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 *YALE L.J.* 729, 746-59 (1992); Lucian Ayre Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of Hadley v. Baxendale*, 7 *J.L. ECON. & ORG.* 284 (1991).

<sup>298</sup> *See* Ayres, *supra* note 223, at 1405 (describing the difficulty in drafting contracts); cf. Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 *S. CAL. INTERDISC. L.J.* 389, 399-402 (1993) (describing the derivation of the “acceptability constraint” functionally).



To inform the judgment of courts and legislatures regarding the selection of default rules, the contractarian paradigm directs these bodies to consider the contract terms that businesses have adopted explicitly. If such terms continue to be widely used, the argument goes, they are likely to be worthy candidates for use as defaults.<sup>299</sup> The law should impose mandatory terms on relationships among business managers and investors only to the extent market failures affect the process by which those terms are adopted.<sup>300</sup>

The SBO, as proposed, would allow participants maximum flexibility to achieve the ideal organizational apparatus. Participants will be faced, in the SBC, with minimal mandatory rules. The result is an emphasis on planning and negotiation. Yet, while these activities involve transaction costs, the benefits of a tailored, rational organizational structure for each business provide the owners the opportunity to focus on relevant objectives, shorn free of the artificial determinations required to satisfy current tax analyses.

### *Conclusion*

Like a puppeteer controlling the movements of legions of puppets, the Treasury and the Service have dictated the forms of states' business organization law for decades. Proof of this is most clearly discerned from the recent waves of enactment of LLCs and LLPs—imperfect business organizations whose structure and content derives from absurd tax structures that ill-serve the smooth and efficient transaction of business. Pandora's Box has been opened and the result is pure folly. Now even the Treasury and Service are questioning their role as puppeteer.

The law governing business organizations is at a watershed: never before has it been so tempting for business lawyers to rely upon one business entity for solving the double-tax/limited liability dichotomy—namely, the LLC. Yet, never before has it been so obvious that the current regime is fraught with problems and uncertainties. Upon close scrutiny, the current regime is fundamentally flawed. Thus, the temptation to merely tinker with the law governing current limited liability entities must be avoided. The substance of business organization law must be reformulated to arrive at an optimal SBC structure and corresponding SBO.

We propose a simple, all-encompassing solution: scrap the current garbage heap of business organization law in favor of a unified business organizational structure divided into the TCC and the SBC. The immediate benefit is a profound simplification of business organization law, together with the certainty and predictability that attends thereto. In addition, economic efficiency, flexibility, and contractual freedom are maximized. At last, substance can triumph over form in the domain of business firms.

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<sup>299</sup> See EASTERBROOK & FISCHEL, *supra* note 31, at 34. It is suggested that the solutions larger corporations offer should be used as default rules because larger firms are "most likely to surmount any transaction hurdle and to spend the most time dealing with the problem once they have elected to do so." *Id.* at 252.

<sup>300</sup> Possible market failures include collective action problems, externalities, and information imperfections that impair the ability of the capital market to price contract terms. See *id.* at 22-30.