

THE LIMITED LIABILITY COMPANY EXPERIMENT: UNLIMITED FLEXIBILITY, UNCERTAIN ROLE

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I

INTRODUCTION

It is fitting that an article about limited liability companies ("LLCs") would be included in a symposium otherwise devoted to partnership law. From the standpoint of form, most states' LLC laws utilize, in varying degrees, provisions clearly of partnership origin.¹ In part, this resemblance probably reflects a judgment that the business relationships for which the LLC is particularly suited will resemble the model of the partnership or closely held corporation² that otherwise would have been the choice of the parties.³ In other cases, language was simply borrowed to facilitate the drafting process; it had been used in the other contexts, and apparently there was no principled objection to its use in the LLC statutes.⁴

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1. Since 1990, there has been an explosion in the amount of scholarship written about the LLC; a comprehensive listing of the literature would already exceed 150 articles. For a recent 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). For an early article that details the corporate and partnership ancestry of the LLC statutes in Wyoming, Florida, and Colorado, see Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387 (1991); see also Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992).

2. There are a number of definitions of the general term "closely held corporation." A workable definition would look to a relatively small number of shareholders, with a substantial portion of their personal wealth invested in the corporation, intimate involvement in its management, and restricted membership in the corporation. See, e.g., Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1676 n.4 (1990).

3. See, e.g., Scott R. Anderson, *The Illinois Limited Liability Company: A Flexible Alternative for Business*, 25 LOY. U. CHI. L.J. 55, 103-04 (1993) ("LLCs, particularly member-managed LLCs, are likely to be closely held . . ."); Keatinge et al., *supra* note 1, at 395 ("Because LLCs restrict the transferability of ownership interests, almost all LLCs will be closely held.").

4. In interpreting the results of such transplantation activities, judges will face the difficult task of determining whether established interpretations of the provisions in their corporate or partnership context should also apply under the unique circumstances of the LLC. As discussed later in this article, fiduciary duties will probably be developed by analogy to partnership or corporate rules. Where the LLC statute is silent, a common issue is whether the corporate doctrine of "piercing the veil" will be extended to the LLC. See generally Gazur & Goff, *supra* note 1, at 401-03; Stacy W. Wood & John T. Woodruff, Comment, *The Oklahoma Limited Liability Company*, 29 TULSA L.J. 397, 408-15 (1994). Some LLC acts expressly incorporate the law applicable to other business entities. See, e.g., ILL. ANN. STAT. 805, 180/10-10 (Smith-Hurd Supp. 1994) (making the liability of a member or manager that of

Although important, those factors shaping the form of LLC legislation have been overshadowed by the influence of the Internal Revenue Code. Because the availability of federal partnership income taxation treatment has been the driving force in the rise of the LLC, the partnership flavor is more decisively dictated by the inclusion of provisions that serve to support classification of the entity as a "partnership" for federal income tax purposes. In that regard, the common LLC statutory requirements of multiple members,⁵ the potential dissolution⁶ upon events occurring with regard to members, and the limited transferability of ownership interests all play roles in securing the desired partnership income tax classification.⁷

Apart from those similarities, the relationship of the LLC to the partnership and other organizational forms promises to be even more profound, while uncertain. On the one hand, the 1990s could witness a fundamental shift in emphasis from other forms of business organization to the LLC. Because of the LLC's superiority in offering both limited liability to participants and federal partnership income tax treatment, it may render obsolete at least the general partnership, limited partnership, and S corporation. At this stage of LLC development, this is not a revelation,⁸ but it does potentially diminish the overall significance of "partnership law,"⁹ except as a default regime principally impacting those who are unaware of its application to their situation, those for

a corporate shareholder or director under comparable circumstances); N.D. CENT. CODE § 10-32-29(3) (Supp. 1993) (extending to LLCs the corporate doctrine of piercing the veil).

5. 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 is uncertain. See generally LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 16.19 (1992). The Internal Revenue Service ("IRS") will consider a ruling request that relates to 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, 1995-3 I.R.B. 20.

6. Most of the LLC statutes use the term "dissolution," and in this article I will generally use that term. The term "dissociation" was introduced in the Uniform Partnership Act (1994) § 601, 6 U.L.A. 322 (Supp. 1995) [hereinafter "RUPA"]. That terminology is used in the Uniform Limited Liability Company Act (1994) § 601 (the "ULLCA") approved by the National Conference of Commissioners on Uniform State Laws at its meeting held July 29-August 5, 1994.

7. See generally Gazur & Goff, *supra* note 1, at 439-52. For a more recent account of the federal income tax issues presented by LLCs, see Susan Pace Hamill, *The Limited Liability Company: A Midpoint Evaluation*, 52 INST. ON FED. TAX'N 1-1 (1994).

8. See, e.g., Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417 (1992).

9. Formal partnership law as such would decline in importance, but the "LLC law" that would rise would probably incorporate substantive concepts of partnership law due to the similarities shared by the relations.

whom the LLC is unavailable,¹⁰ or those for whom limited liability is not important.¹¹

The importance of the legal issues surrounding those organizational forms would also apparently share those declining fortunes. For example, the so-called "paternalist" versus "contractarian" debate in corporate¹² and partnership¹³ law is potentially of less overall consequence to the extent that those forms of organization are bypassed by the emergence of the LLC. On the other hand, the partnership's apparent march to decreased importance is neither inevitable nor irreversible. Since both general and limited partnerships already enjoy federal income tax partnership classification, the LLC's principal comparative advantage is limited liability for all participants. As will be discussed in this article, the fast emerging "limited liability partnership" and "registered limited liability partnership" provisions adopted by several states limit the traditional liability of general partners.¹⁴ If such limitations were widely expanded to include all partnerships and types of liability,¹⁵ interest in the familiar partnership forms would probably be rekindled.

10. See, e.g., LA. REV. STAT. ANN. § 12:1302A (West 1994) (prohibiting use of LLC for banking or insurance underwriting or operation of homesteads or building and loan associations); NEV. REV. STAT. ANN. § 86.141 (Michie 1994) (prohibiting use in banking or insurance business); N.H. REV. STAT. ANN. § 304-C:7I (1994 Supp.) (prohibiting use of LLC in banking, construction or maintenance of railroads (unless permitted by New Hampshire Department of Transportation), business of contracts for payment of money at a fixed date or upon some contingency, or business of a trust, surety, indemnity, or safe deposit company); OR. REV. STAT. § 63.074(2) (1994 Supp.) (prohibiting performance of professional services by an LLC); R.I. GEN. LAWS § 7-16-3 (1992) (prohibiting performance of professional services by an LLC); WYO. STAT. § 17-15-103 (1994 Supp.) (prohibiting use in banking or insurance business). Even if the language of the LLC statute is enabling, other state statutes may impose limitations. See, e.g., OKLA. STAT. ANN. tit. 18 § 955A.5 (West 1995 Supp.) (rules on the use of entities, including LLCs, for the business of farming or ranching).

11. If the parties appreciate the consequences of their actions, but nevertheless prize the simplicity of a handshake deal over the limited liability of the LLC, partnership law, with decades of judicial development and practitioner experience, offers guidance as to matters for which there is no agreement. Although the implementation of RUPA may upset that predictability, the partnership still provides more certainty in the absence of extensive written agreement. Although analogies might be made to comparable provisions in partnership or corporate law for guidance, the LLC is an untested commodity. If, however, limited liability is important to the participants, then the LLC will clearly be preferred, assuming that it is available.

12. See, e.g., Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879; Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986); Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291 (1992); Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

13. 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 (1993); Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45 (1993); Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523 (1993).

14. See *infra* notes 183-87 and accompanying text.

15. Some of the provisions are available only to professional partnerships. Others address only the vicarious liability for copartner torts, and exclude other partnership obligations. See *infra* notes 183-87 and accompanying text.

If the ever-increasing popularity of the LLC does ultimately diminish the importance of the other forms of business organization, the emergence of the LLC will not represent simplification. The LLC's future will be marked by legislative, judicial, regulatory, and practitioner experimentation with the new entity, revisiting issues already settled in other contexts. The law relating to the long-standing forms of business organization will not be irrelevant, because LLC law will develop through a heavy emphasis on analogy. Moreover, many of the continuing controversies, such as the paternalist/contractarian viewpoints, will be revisited in the context of the LLC. In that regard, the Uniform Limited Liability Company Act¹⁶ (the "ULLCA") recently adopted by the National Conference of Commissioners on Uniform State Laws, while very flexible and contractarian overall, incorporates as a nonwaivable core many of the controversial fiduciary duty aspects of the Revised Uniform Partnership Act¹⁷ ("RUPA"). In contrast, several LLC statutes¹⁸ do not include such limitations.

Much of the uncertainty, and resulting cost, is the predictable result of new legislation. One could question the desirability of the LLC as a state level "Band-Aid" in response to structural problems in the federal income tax.¹⁹ However, I will not join in the already ample criticism of the federal income taxation of business organizations and will instead focus on the uncertainty surrounding the LLC produced by the open-ended "flexible" quality of much LLC legislation. A common solution for uncertainty is a uniform statute, and the ULLCA is being offered in this regard. Much of the uniformity will be provided only with respect to the default provisions, inasmuch as the ULLCA itself is crafted in a flexible manner in which the agreement of the parties controls. The certainty provided by the ULLCA could therefore be illusory when the parties depart from the default rules. On the other hand, as noted above, the ULLCA imposes a nonwaivable core of fiduciary obligations, while some of the existing LLC statutes do not follow this approach. I conclude that, for most users of the LLC, this difference will not be of enough significance to create preferences among LLC statutes and competition among states catering to demand based on such preferences. If that proves accurate, some degree of uniformity, although not necessarily along the lines of the ULLCA, will develop. However, I will also argue that the extent of the flexibility of the LLC is still largely unknown and untested, and could well extend beyond assumed boundaries. If the LLC were to spread to publicly traded entities, for example, where "race" dynamics have been observed, or at least debated,²⁰ the flexibility

16. See *supra* note 6.

17. For a discussion of the fiduciary law issues, see *infra* part IV.

18. The Arkansas and Delaware LLC acts are highly flexible in this regard. See *infra* notes 111-17, 120-28 and accompanying text.

19. For a brief discussion of this issue, particularly in terms of the S corporation, see *infra* notes 196-99, 274-78 and accompanying text.

20. The "race" generally refers to competition among states, reflected in their corporate law, to be the jurisdiction of choice for corporate formations. For a listing of some of the extensive literature discussing this topic, see *infra* note 244.

of the LLC might require constraints while the impact of such flexibility, both in terms of costs and overall policy, is assessed. Such limitations could confine the LLC to its original mission as a flexible, tax-advantaged vehicle primarily for small business.

The remainder of this article is divided into six parts. The first, Part II, presents a bare-bones history of the LLC, primarily framed in terms of the evolution from so-called "bulletproof" to "flexible" statutes. Part III briefly discusses the ULLCA as a model of flexible legislation. Part IV examines the paternalist and contractarian influences on the emerging models of LLC internal governance. This issue is admittedly unsettled with regard to the established forms of business organization, and it is not surprising to see it resurface as a matter of first impression in terms of LLC fiduciary duties. Part V then addresses boundaries and the role of the LLC's flexibility in the possible supplantation of other forms of business organization. Part VI offers a brief assessment of the apparent forces driving LLC legislation and the potential for competition among the states for LLC formations in an unsettled environment of forty-seven different state LLC statutes. The article concludes with Part VII.

II

THE RISE OF THE LLC

The history of the LLC has by now received so much scholarly attention that it will not be repeated here beyond the essential facts.²¹

A. The Wyoming Experiment

In 1977 Wyoming adopted the first modern²² limited liability company act in the United States.²³ The Wyoming LLC statute was enacted by the Wyoming legislature at the behest of an oil company seeking a new entity that would provide limited liability and, hopefully, federal partnership income tax treatment.²⁴ Unlike many of the states offering LLC acts in later years,

21. See *supra* note 1 (referring to the large number of articles previously written about the LLC).

22. The limited partnership association, adopted in Pennsylvania, Michigan, New Jersey, and Ohio in the 1870s, was arguably the LLC's unsuccessful ancestor. See Gazur & Goff, *supra* note 1, at 393-94. The Wyoming statute utilized some language from the Ohio limited partnership association statute. *Id.* at 395.

23. Outside the United States, the limited liability company concept was introduced in Germany in 1892 with law authorizing the formation of the private limited company, the *Gesellschaft mit beschränkter Haftung*. The business form was adopted by a number of other countries. See Gazur & Goff, *supra* note 1, at 394. For a contemporary comparison, 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 (1994).

24. Hamilton Brothers Oil Company reportedly had their tax accountants and legal counsel draft the legislation and present it to the Wyoming legislature. See Phillip P. Whynott, *North American Trade Treaty Stimulates Interest in US LLCs: A Historical Update*, 1 LLC REP. 93-106 to -107 (1993).

Wyoming had little to lose because it levied no individual or corporate income tax.²⁵

Florida followed with LLC legislation in 1982, reportedly to attract foreign investors familiar with the Latin American *limitada*.²⁶ Although there were federal income tax advantages to the LLC for domestic and foreign investors alike, Florida was not generous with respect to the state tax aspects of the LLC. Florida is almost unique in its treatment of the LLC as a corporation for purposes of its state corporate income tax.²⁷

The Internal Revenue Service (the "IRS") began a study of the LLC in 1982 and suspended the further issuance of private letter rulings concerning the classification of LLCs as partnerships for federal income tax purposes.²⁸ No states joined Wyoming and Florida in adopting LLC legislation, apparently because of uncertainty produced by the continuing study. However, other ensuing developments made the LLC an even more promising vehicle. The Tax Reform Act of 1986 in particular created additional incentives for the adoption of forms of organization that avoided the corporate income tax.²⁹ While the limited partnership and S corporation likewise offered the desired combination of conduit taxation and limited liability, there were significant drawbacks to both alternatives.³⁰

Although questions about the federal income tax classification of the LLC remained for future interpretation, many were answered with the completion of the IRS study and issuance in 1988 of a landmark revenue ruling granting a favorable classification for the Wyoming LLC.³¹ With the tax consequences of the LLC more assured, Colorado and Kansas started the second wave of LLC

25. Wyoming still has no individual or corporate income tax. The state does collect a fee upon filing the original articles of organization or issuing a certificate of authority for a foreign limited liability company, and that fee is based on the capital of the LLC. For capital in excess of \$100,000, the fee is computed as \$200 plus \$1 for each additional \$1,000 of capital in excess of \$100,000. In no event shall the fee exceed \$25,000. An annual tax of \$100 is also due and payable annually. See WYO. STAT. § 17-15-132 (Supp. 1994).

26. See Richard Johnson, Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387 (1983).

27. See FLA. STAT. ANN. § 608.471 (West 1993 & Supp. 1995). For a discussion of the state taxation of LLCs, see *infra* notes 250-54 and accompanying text.

28. See Gazur & Goff, *supra* note 1, at 444-45.

29. See *id.* at 391. Those pressures were reduced somewhat by the Revenue Reconciliation Act of 1993. See *infra* notes 198-99 and accompanying text.

30. The disadvantages of the limited partnership and S corporation forms have been discussed in almost every article concerning LLCs and will not be examined here in any depth. Briefly, the limited partnership requires a corporate general partner to assure limited liability for all participants, and limited partners can lose their limited liability if they participate in control of the business. The risk of limited partner liability, however, was significantly reduced by the 1985 amendments to the Revised Uniform Limited Partnership Act. See *infra* note 190. The S corporation limits the number of permissible shareholders to 35, excludes certain persons (like corporations and nonresident alien individuals) from stock ownership, prohibits more than one economic class of stock, does not permit so-called "special allocations" of income or deductions, and the mechanics of basis determinations in claiming losses from operations are disadvantageous as compared with those enjoyed by partners. See Gazur & Goff, *supra* note 1, at 452-62.

31. Rev. Rul. 88-76, 1988-2 C.B. 360.

legislation by enacting statutes in 1990. Four states enacted LLC statutes in 1991,³² ten did so in 1992,³³ eighteen adopted legislation in 1993,³⁴ and eleven additional states embraced the LLC in 1994.³⁵ The IRS contributed to the momentum by issuing additional favorable revenue rulings and private letter rulings that became progressively more liberal.³⁶ Presently, forty-seven states have some version of LLC legislation³⁷; only Hawaii, Massachusetts, and Vermont do not.

B. The "Bulletproof" Approach

The Wyoming statute was fashioned from a combination of provisions from the Uniform Limited Partnership Act, the Model Business Corporation Act, and the Ohio limited partnership association statute.³⁸ To ensure favorable partnership characterization by the IRS, several key provisions supporting that result were included in the Wyoming act, and those provisions could not be modified by the organizers.³⁹ If the overall statutory scheme were accepted by the IRS, it would be difficult for a drafter in the ordinary course to create an LLC that did not qualify as a partnership for federal income tax purposes,⁴⁰ so the statute was considered to be "bulletproof."

Following Revenue Ruling 88-76, drafters of legislation were reluctant to depart significantly from the proven formula. In the early stages of the LLC's development, several states⁴¹ followed the Wyoming format with respect to the

32. Nevada, Texas, Utah, and Virginia.

33. Arizona, Delaware, Illinois, Iowa, Louisiana, Maryland, Minnesota, Oklahoma, Rhode Island, and West Virginia.

34. Alabama, Arkansas, Connecticut, Georgia, Idaho, Indiana, Michigan, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Oregon, South Dakota, and Wisconsin.

35. Alaska, California, Kentucky, Maine, Mississippi, New York, Ohio, Pennsylvania, South Carolina, Tennessee, and Washington.

36. See *infra* notes 271-73 and accompanying text.

37. Even if a state has enacted LLC legislation, the use of the LLC form for certain business activities (for example, banking, insurance, or professional services) can be prohibited by the LLC statute or other state laws. See *supra* note 10.

38. For a section-by-section analysis of the derivation of the Wyoming, Florida, and Colorado statutes, see Gazur & Goff, *supra* note 1, at 472-501.

39. The Wyoming statute required unanimous member approval for the admission of transferees as members, WYO. STAT. § 17-15-122 (1977), and unanimous member consent to continuation of the LLC upon an event of dissolution, *id.* § 17-15-123(a). The statute was converted to flexible status effective July 1, 1995. See 1995 WYO. SESS. LAWS 79 (creating WYO. STAT. § 17-15-144 and amending WYO. STAT. §§ 17-15-102 and 17-15-107 (1977))(LEXIS, Legis. Library, WYALS file).

40. One could push the boundaries of even a bulletproof statute and create potential problems. If all of the members are controlled by common interests, partnership tax status can be jeopardized. See Rev. Rul. 93-4, 1993-1 C.B. 225 (dealing with the characterization of a German GmbH comprised of two domestic subsidiaries wholly owned by one parent company); see also Hamill, *supra* note 7, at 16-17. The IRS reportedly also takes a dim view of binding agreements to continue an LLC, made in advance of the event of dissolution. *News Briefs-Visit to the IRS*, 2 LLC REP. 94-201 (1994) ("[A]ny prior agreement concerning continuation or admission of transferees [sic] will result in the adoption of corporation characteristics that may result in the loss of partnership tax treatment.").

41. See, e.g., COLO. REV. STAT. §§ 7-80-101 to 7-80-913 (Supp. 1990) (the statute was converted to flexible status, effective July 1, 1994, see COLO. REV. STAT. §§ 7-80-101 to 7-80-913 (Supp. 1994)); NEV.

provisions that were considered to be tax sensitive. The unmodifiable, cumbersome requirements of unanimous member approval of transfers of interest and of continuation of the LLC upon an event of dissolution, which answered income tax concerns,⁴² also produced the practical state law consequence of confining the LLC to business arrangements with limited membership.⁴³ Even if would-be organizers did not seek,⁴⁴ or wished to experiment with, partnership tax classification and wanted a less restrictive structure, such modifications were precluded by state law.

C. The "Flexible" Statutes

The bulletproof statutes did offer less opportunity for scrivener malpractice in income tax classification matters.⁴⁵ However, this approach could have frozen the LLC tax treatment in the mold of the 1977 Wyoming statute at a time when the IRS was significantly liberalizing its overall approach to the partnership tax classification issue.⁴⁶ It was also inevitable that, as the IRS and practitioners gained more experience with the emerging entity, the partnership classification issues as applied to the LLC would benefit from refinements in interpretations of the tax law.⁴⁷

REV. STAT. ANN. §§ 86.010-86.571 (Michie 1994); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to 47-34-59 (Supp. 1994)); VA. CODE ANN. §§ 13.1-1000 to 13.1-1073 (Michie 1993) (the statute was converted to flexible status in 1994, *see* VA. CODE ANN. §§ 13.1-1040 & 13.1-1046 (Supp. 1994)); W. VA. CODE §§ 31-1A-1 to 31-1A-69 (Supp. 1994).

42. *See supra* note 7.

43. One would assume that states would be reluctant to embrace the LLC because, if taxed as a partnership for state purposes, LLCs would produce an erosion of the state corporate tax base. This concern has been raised in some states but has ultimately bowed to the political forces propelling the LLC's ascent, sometimes with the addition of special fees or taxes on LLC income, membership, or other bases. *See infra* text accompanying notes 247-82 for a discussion of the state fiscal issues and the constituencies championing the LLC.

44. At this time, most LLC organizers would presumably desire partnership income tax treatment. That preference could change with shifts in the individual income tax rate versus corporate tax rate differential or other larger changes to the federal income tax structure. *See infra* text accompanying notes 198-99 for a brief discussion of those factors. Barring such changes, LLC organizers might focus on the state law aspects of the LLC, like the flexibility in structuring internal governance mechanisms discussed in this article, as a substitute for the C corporation, for which pass-through treatment may not be desired or possible (because of the unavailability of the S election or due to publicly traded partnership limitations). *See infra* text accompanying notes 196-243 for a discussion of potential function of LLCs as a substitute for closely held and publicly held corporations.

45. Problems could still arise in that regard. *See supra* note 40.

46. On May 4, 1992, the IRS published its position for private letter ruling purposes: a partnership would not be considered to have continuity of life if, after an event of dissolution, only a majority in interest of the remaining partners agreed to continue the business of the partnership. *See* Rev. Proc. 92-35, 1992-1 C.B. 790. This was a significant liberalization of the requirement contained in the regulations that prescribed unanimous consent of the partners. *See* Treas. Reg. § 301.7701-2(b)(1) (1983). On July 22, 1992, the IRS proposed a corresponding revision to the regulations. Under the proposed regulation, a partnership would lack continuity of life if a vote of "at least a majority in interest" of the remaining partners were required, as opposed to the unanimous vote required by the prior language. The proposed regulation was finalized on June 14, 1993. *See* T.D. 8475, 1993-24 I.R.B. 11.

47. The increasing volume of private letter rulings and public revenue rulings, numbering over 35, brought new guidance concerning the IRS treatment of the LLC. The revenue ruling addressing the Utah LLC statute was of particular importance because it found the absence of free transferability of

The Texas statute was the first to depart dramatically from the Wyoming model's mandatory core provisions. It expressly permitted the formation of a one-member LLC,⁴⁸ and it reduced to default provisions the unanimity requirements for approvals of transfers of interests and continuation.⁴⁹ This flexibility permitted the drafters of Texas LLCs to adapt to the subsequent IRS acceptance of simple majority approval for transfers of member interests⁵⁰ and continuation upon an event of dissolution.⁵¹ "Flexibility" has since become the dominant pattern in LLC legislation, both in new statutes and in modifications of existing bulletproof laws.⁵² As discussed below, this flexibility extends far beyond tax sensitive provisions.

III

THE TRIUMPH OF CONTRACT

A. More Than a Tax Gimmick

The Wyoming LLC statute was designed and drafted to provide a limited liability entity offering partnership income tax treatment. The legislation was practical and unadorned in style, and aside from the limited liability shield and unavoidable operational guidance, the state law aspects were of little apparent consequence apart from their income tax roles. With respect to limited liability, the pressing concern was whether the limited liability of LLC members would be respected in jurisdictions lacking LLC legislation.⁵³

While the move to flexible statutes was prompted by a need to accommodate the evolving income tax classification law, the flexible statutes also planted the seeds for a fundamental shift in emphasis to purely state law issues. The

interest, although the approval of only a majority of interest of the remaining members was required to admit a transferee as a new member. *See* Rev. Rul. 93-91, 1993-2 C.B. 316. On July 11, 1994, the IRS issued Rev. Proc. 94-46, 1994-28 I.R.B. 129, that sets forth a safe harbor test for determining what constitutes a majority in interest of partners for purposes of the continuation of a partnership upon dissolution. On January 17, 1995, the IRS issued Rev. Proc. 95-10, 1995-3 I.R.B. 20, that establishes comprehensive guidelines tailored to LLCs for the issuance of rulings concerning their classification as partnerships for federal tax purposes.

48. *See* TEX. REV. CIV. STAT. ANN. 1528n § 4.01A (West Supp. 1995).

49. *See id.* § 4.07A (assignee may become a member if and to the extent that the LLC regulations provide or all members consent); *id.* § 6.01B (an LLC is not dissolved if the business is continued by the vote of the members as stated in the articles of organization or regulations of the LLC, or if not so stated, by all remaining members).

50. *See supra* note 47.

51. *See supra* note 46.

52. For example, effective July 1, 1994, Colorado amended its formerly bulletproof statute to permit one-member LLCs and less than unanimous approval to admit transferees as members and to continue the LLC upon an event of dissolution. *See generally* Risa Lynn Wolf-Smith, *Colorado LLCs: New and Improved*, 23 COLO. LAW. 1473 (1994).

53. This concern is rapidly diminishing in significance with the dwindling number of states lacking LLC statutes. For a discussion of this issue, see Gazur & Goff, *supra* note 1, at 427-37. The absence of limited liability would remain as a concern for groups, like professionals, for whom formation as an LLC is not permitted. In part, the limited liability partnership is a response to such concerns. *See infra* text accompanying notes 263-70.

contractual nature of flexible LLC statutes extended beyond simply replacing the potentially cumbersome mandatory provisions that marked the bulletproof style, and opened the LLC to relatively unlimited, unregulated variations in governance and financial provisions. The following materials discuss the ULLCA approach to flexibility.

B. The Uniform Limited Liability Company Act

The drafters of the ULLCA have established a framework for an entity that, except for routine filing and procedural requirements,⁵⁴ can be fashioned almost entirely by the agreement of the members. Subject to several exceptions, the operating agreement governs the "relations among the members, managers, and the limited liability company."⁵⁵ The statute therefore plays primarily a default role. The exceptions to freedom of contract are largely drawn from RUPA. For example, the operating agreement cannot "unreasonably restrict a member's or former member's right of access to books or records."⁵⁶ The operating agreement cannot vary the right to expel a member upon a judicial determination of wrongdoing,⁵⁷ vary the requirement to wind up the LLC business under certain circumstances,⁵⁸ or restrict the rights of third parties under the Act.⁵⁹ As can a general partner, any member can ask a court to dissolve the LLC if the continued operations of the company will otherwise be

54. See, e.g., ULLCA §§ 105 (LLC name), 106 (reservation of name), 108 (designated office and agent for service of process), 109 (change of designated office or agent for service of process), 111 (service of process), 202 (rules of formation), 205 (signing of records), 206 (filing rules).

55. *Id.* § 103(a).

56. *Id.* § 103(b)(1). Compare RUPA § 103(b)(2), U.L.A. at 288 (Supp. 1995) (a partnership agreement may not unreasonably restrict the right of access to books and records).

57. ULLCA § 103(b)(5). This paragraph refers to the right to expel a member under the events specified in ULLCA § 601(5) (dealing with a member's expulsion by judicial determination because the member engaged in wrongful conduct that adversely and materially affected the company business, willfully or persistently committed a material breach of the operating agreement or of a duty owed to the company or other members under ULLCA § 409 (dealing with fiduciary duties and conduct), or engaged in conduct relating to the company business which makes it not reasonably practicable to carry on the business with the member). Compare RUPA § 103(b)(7), 6 U.L.A. at 289 (Supp. 1995) (dealing with the right of a court to expel a partner in the events specified in RUPA § 601(5), which resemble the ULLCA events).

58. ULLCA § 103(b)(6). The situations are specified in ULLCA § 801(4) (dealing with an event that makes it unlawful for all or substantially all of the business of the LLC to be continued), or 801(5) (dealing with a judicial decree that the economic purpose of the LLC is likely to be unreasonably frustrated, another member has engaged in conduct related to the LLC business that makes it not reasonably practicable to carry on the business in the LLC with that member, it is not otherwise reasonably practicable to carry on the company business in conformity with the articles of organization and operating agreement, the member has the right to have the business wound up for failure to purchase a dissociating member's interest, or the manager or members in control are acting in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioning member). Compare RUPA § 103(b)(8), 6 U.L.A. at 289 (Supp. 1995) (a partnership agreement may not vary the requirement to wind up the partnership business in cases specified in RUPA § 801(4), (5), or (6), which resemble the ULLCA events).

59. ULLCA § 103(b)(7). The RUPA section is identical. See RUPA § 103(b)(9), 6 U.L.A. at 289 (Supp. 1995).

adversely affected.⁶⁰ The ULLCA further provides an additional and nonwaivable dissolution remedy that is not found in RUPA and is more corporate in tone: A member can ask that a court dissolve the LLC if “the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent or unfairly prejudicial to the petitioning member.”⁶¹ Under the ULLCA model, the minority may therefore have an additional measure of protection from oppression beyond that provided in most corporate statutes.⁶² As discussed later, the remaining restrictions on modifications center on fiduciary duties, again adopting the RUPA model.⁶³

The ULLCA in its default provisions closely resembles RUPA, to the degree that the same section numbers are used for corresponding provisions.⁶⁴ As a default matter, the ULLCA permits a member to dissociate at will,⁶⁵ and a member is dissociated upon bankruptcy⁶⁶ or death.⁶⁷ While these aspects cannot be modified under RUPA,⁶⁸ the ULLCA permits such provisions to be overridden in the operating agreement.⁶⁹ With respect to transferability of interests, the ULLCA follows the partnership model and, in the absence of contrary provisions in the operating agreement, requires the consent of other members for the admission of new members.⁷⁰

Tax-sensitive partnership mimicking aside, there are fundamental differences in the nature of the partnership and LLC relations. For example, while a

60. Compare ULLCA § 801(5)(i)-(iv) (dissolution is unwarranted if the court holds that the economic purpose of the company is likely to be unreasonably frustrated, another member has engaged in conduct relating to the company business that makes it not reasonably practicable to carry on the business in the company with that member, it is not otherwise reasonably practicable to carry on the company business in conformity with the articles of organization and operating agreement, or upon failure to purchase a dissociating member's interest) with RUPA § 801(5), 6 U.L.A. at 335 (Supp. 1995).

61. ULLCA § 801(5)(v).

62. This is somewhat broader than the corporate judicial dissolution provisions found in statutes like the Model Business Corporation Act. See *infra* notes 209-13 and accompanying text.

63. See *infra* notes 80-91 and accompanying text.

64. See, e.g., RUPA § 102 and ULLCA § 102 (knowledge and notice); RUPA § 103 and ULLCA § 103 (nonwaivable provisions); RUPA § 601 and ULLCA § 601 (events causing dissociation); RUPA art. 9 and ULLCA art. 9 (conversions and mergers).

65. ULLCA § 602(a) states that a member has the power to dissociate at any time, rightfully or wrongfully, by express will pursuant to section 601(1). Section 601(1) provides that a member is dissociated upon the company having notice of the member's express will to withdraw. However, this is only a default provision because section 103 would not prohibit an operating agreement that would eliminate this power.

66. See *id.* § 601(6).

67. See *id.* § 601(7).

68. “A partnership agreement may not . . . (6) vary the power to dissociate as a partner under Section 602(a), except to require the notice under Section 601(1) to be in writing.” RUPA § 103(b)(6), 6 U.L.A. at 289 (Supp. 1995).

69. The list of unmodifiable provisions does not include these matters. See ULLCA § 103. Although inconsistent with the absence of personal liability and the treatment of corporate shareholders, the dissociation of LLC members upon such events was included in the first and following LLC statutes to avoid “continuity of life” for purposes of income tax classification.

70. See ULLCA § 503(a) (a transferee may become a member if and to the extent the transferor gives that right in accordance with the authority described in the operating agreement, or if all other members consent). The income tax consequences again dictated this approach.

general partnership can be inadvertently created,⁷¹ all LLC statutes require the public filing of an instrument of formation.⁷² General partners have potentially unlimited liability for enterprise obligations,⁷³ while the liability of LLC members is limited to their investment.⁷⁴ Each partner is an agent of the partnership,⁷⁵ while in a manager-managed LLC, a member is not an agent of the LLC solely by reason of being a member.⁷⁶

With respect to management, the LLC can adopt a partnership/close corporation structure or one resembling centralized corporate governance. The members can opt for a "member-managed" format, in which "each member has equal rights in the management and conduct of the company business."⁷⁷ If, on the other hand, the LLC is "manager-managed," the managers have "the exclusive authority to manage and conduct the company business."⁷⁸ Although the degree of centralized management has tax classification consequences, this broad flexibility is almost unique to the LLC form.⁷⁹

IV

THE FIDUCIARY DUTY CAFETERIA: FLEXIBILITY, UNCERTAINTY, OR LIMITED DIRECTION

Although most of the more recent LLC statutes share the "flexible" characterization, they still differ in terms of the degree of freedom given to the parties to fashion their own business arrangement. In an effort to examine the potential for uniformity in the law, this section emphasizes those aspects of the

71. See, e.g., RUPA § 202(a), 6 U.L.A. at 295 (Supp. 1995) ("[T]he association of two or more persons to carry on as co-owners a business for profit creates a partnership, whether or not the persons intend to create a partnership."). The ULLCA, however, does not require a for-profit enterprise. See ULLCA § 112(a) (permitting organization for any lawful purpose); *id.* § 112(b)(8) (permitting an LLC to conduct its "business" within or without the state of organization); *id.* § 101(3) ("Business" includes "every trade, occupation, profession, and any other lawful activity, whether or not entered into for profit.").

72. See, e.g., ULLCA § 205(a); ARIZ. REV. STAT. ANN. § 29-601.11 (Supp. 1993); CONN. GEN. STAT. ANN. § 2(14) (West 1994); GA. CODE ANN. § 14-11-101(18) (1994); IDAHO CODE § 53-601(11) (1994); ILL. ANN. STAT. 805, 180/1-5 (Smith-Hurd Supp. 1994); IND. CODE ANN. § 23-18-1-16 (Burns Supp. 1994); LA. REV. STAT. ANN. § 12.1301(16) (West Supp. 1994); MO. ANN. STAT. § 347.015(13) (Vernon Supp. 1994); MONT. CODE ANN. § 35-8-102(16) (1993); N.C. GEN. STAT. § 57C-1-03(16) (1993).

73. See, e.g., RUPA § 306, 6 U.L.A. at 306 (Supp. 1995) (all partners are liable jointly and severally for all obligations of the partnership).

74. An LLC member would be liable for torts committed by that person and could be liable for entity obligations under a "piercing" analysis. See *supra* note 4.

75. See, e.g., RUPA § 301, 6 U.L.A. at 299 (Supp. 1995).

76. See ULLCA § 301(b).

77. See *id.* § 404(a).

78. See *id.* § 404(b).

79. The corporate form can exhibit some flexibility with the aid of "Close Corporation" statutes that, for example, permit the elimination of the board of directors and governance resembling a partnership. See *infra* notes 196-218 and accompanying text. However, in some cases, close corporation legislation, as a separate supplementary statute, is not available to corporations with "too many" shareholders. See, e.g., MODEL STATUTORY CLOSE CORP. SUPP. § 3(b) (corporation must have 50 or fewer shareholders).

LLC that cannot be modified by the parties. If the differences in flexibility with respect to those unalterable aspects are important to organizers of LLCs, those differences will presumably create preferences among competing LLC statutes. The principal differences arise with respect to the appropriate fiduciary standards of member and manager conduct; those standards are discussed in the materials that follow. The fiduciary duty issue demonstrates another theme of this article: the open and uncertain quality of LLC law and the reconsideration of many issues already well developed in other contexts.

A. The Uniform Limited Liability Company Act

1. *The Nonwaivable Core of Duty.* The ULLCA adopts the RUPA fiduciary duty provisions that continue to generate fundamental disagreement on the nature of fiduciary duties and the permissible bounds of contractual freedom.⁸⁰ One of the drafters of the ULLCA has written that the fiduciary standards were included due to “notions of fundamental fairness and investor protection.”⁸¹ In that regard, the only fiduciary duties are the duty of loyalty and the duty of care.⁸² Although not identified as “fiduciary,” duties under the Act or under the operating agreement are to be discharged “consistently with the obligation of good faith and fair dealing.”⁸³ In a member-managed LLC, all of the members owe these duties to the LLC and the other members. In a manager-managed LLC, managers and members exercising managerial authority are held to the same standards.⁸⁴

The ULLCA also adopts the RUPA restrictions on modifying the specified duties. The operating agreement cannot eliminate the duty of loyalty, but the agreement may “identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable.”⁸⁵ The operating

80. See *supra* note 13.

81. Jack Burton, *Preview: The Uniform Limited Liability Company Act*, 2 LLC REP. 94-409, 94-411 (1994).

82. ULLCA § 409(a). ULLCA § 409(b) prescribes member duties of loyalty resembling those in RUPA § 404(b), and ULLCA § 603 addresses the periods for which the duties apply, resembling RUPA § 603. The duty of care is prescribed by ULLCA §§ 409(c): “A member’s duty of care to the limited liability company and the other members in the conduct and winding up of the limited liability company business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.” This provision resembles RUPA § 404(c). ULLCA § 603(b)(3) addresses the time periods for which the duty applies and resembles RUPA § 603.

83. ULLCA § 409(d) (“A member shall discharge the duties to a member-managed limited liability company and other members under this [Act] or under the operating agreement and exercise any rights consistently with the obligation of good faith and fair dealing.”). This corresponds to RUPA § 404(d).

84. This aspect is very pliable with respect to manager-managed LLCs. It is first stated that a member who is not otherwise a manager has no duties to the LLC or other members solely by reason of being a member. See ULLCA § 409(h)(1). This language may not foreclose fiduciary duties as a controlling, but nonmanaging member. See *infra* note 123. However, a member who exercises the rights of a manager is held to the standards of conduct. See ULLCA § 409(h)(3). Conversely, a manager is relieved of liability for violation of the standards to the extent aspects of the managerial authority is reserved to the members. See ULLCA § 409(h)(4).

85. ULLCA § 103(b)(2)(i). This is essentially the same provision as RUPA § 103(b)(3).

agreement cannot “unreasonably reduce”⁸⁶ the duty of care, which otherwise is “refraining from . . . grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.”⁸⁷ The operating agreement cannot eliminate the obligation of good faith and fair dealing, but the agreement “may determine the standards by which performance of the obligation is to be measured, if the standards are not manifestly unreasonable.”⁸⁸

The desirability of the RUPA approach to fiduciary duties in the partnership context is ably addressed by several papers in this symposium.⁸⁹ Based on past commentary, few analysts seem pleased with RUPA’s compromise approach,⁹⁰ which has been largely transplanted into the ULLCA. Aside from the larger debate on the appropriate scope of fiduciary duty, some of the observations about the choice of statutory language could equally apply to the LLC in the ULLCA context. For example, the manifestly slippery nature of “not manifestly unreasonable” as a guideline for drafters has already been noted.⁹¹

2. *Indemnification and Derivative Actions.* Indemnification is only lightly touched upon in the ULLCA.⁹² The drafters have not addressed the relationship of indemnification to claims against members or managers arising in connection with breaches of the duties of care or loyalty. A broad indemnification provision could operate in a manner that would “eliminate” or “unreasonably reduce” those duties or would otherwise frustrate public policy considerations.⁹³ On the other hand, members of an LLC formed under the ULLCA

86. ULLCA § 103(b)(3). This corresponds to RUPA § 103(b)(4).

87. ULLCA § 409(c).

88. *Id.* § 103(b)(4). This corresponds to RUPA § 103(b)(5). See Robert M. Phillips, Comment, *Good Faith and Fair Dealing Under the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 1179 (1993) (discussing the implications for abuses of an undefined good faith and fair dealing standard). The RUPA provision was adapted from § 1-102(3) of the Uniform Commercial Code. See RUPA § 103 cmt. 2, 6 U.L.A. 289 (Supp. 1995).

89. See J. Dennis Hynes, *Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract*, 58 LAW & CONTEMP. PROBS. 29 (Spring 1995); Allan W. Vestal, *Advancing the Search for Compromise: A Response to Professor Hynes*, 58 LAW & CONTEMP. PROBS. 55 (Spring 1995).

90. Some believe that RUPA inappropriately shrinks the scope of fiduciary duties that had been previously developed. See, e.g., Vestal, *supra* note 13. Those with a contractarian perspective believe that the nonwaivable core of duties is overly extensive. See, e.g., Ribstein, *supra* note 13.

91. Ribstein, *supra* note 13, at 60 (“These qualifications are so vague that sophisticated planners would be foolish to rely on them, but are sure to enmesh in litigation unfortunate partners who attempt private ordering of fiduciary duties. . . .”). Such flexible language is not, however, uncommon. The Model Business Corporation Act, for example, uses the manifestly unreasonable standard in addressing the validity of stock transfer restrictions, an admittedly more circumscribed subject. MODEL BUSINESS CORP. ACT § 6.27(d)(4) (1985). The language in the ULLCA and RUPA was adapted from U.C.C. § 1-102(3). See *supra* note 88. Commercial cases interpreting that passage are not particularly helpful. See *infra* note 173.

92. “A limited liability company shall reimburse a member for payments made and indemnify a member for liabilities incurred by the member in the ordinary course of the business of the company or for the preservation of its business or property.” ULLCA § 403(a).

93. A literal reading of the ULLCA’s list of unmodifiable provisions arguably permits the operating agreement’s removal of a member’s right to bring a derivative action. See ULLCA §§ 103, 1101. Due to the unguided nature of the provision, courts could impose their view of public policy in this regard, as suggested by the legislative treatment of this issue with respect to corporations. The Model Business Corporation Act, for example, prohibits indemnification if a director is found liable to the corporation

potentially have a strong hand in dealing with breaches of fiduciary duty or oppressive behavior, owing to their power to request the dissolution of the entity in the event of such misconduct.⁹⁴

Reflecting the potential for passive, nonmanaging members, the ULLCA expressly provides for derivative actions.⁹⁵ The statute also entertains direct actions against a "limited liability company or another member for legal or equitable relief"⁹⁶ with respect to a number of rights, including fiduciary rights. However, the excerpted language apparently exempts nonmember managers as defendants.

B. State Experimentation with LLC Fiduciary Duty

If competition for LLC formations is to develop among the states, then, other factors being equal,⁹⁷ some important and unalterable differences are likely to arise under the competing statutes. With the ULLCA as a model, those differences center on fiduciary duties. The following discussion accordingly continues that theme with reference to the fiduciary duty models employed by existing statutes.

1. *No Express Standards.* Several of the extant statutes do not express standards of manager or member conduct.⁹⁸ That silence should not present a significant obstacle to judges in fashioning fiduciary duties since rough analogies can be drawn to corporate directors in a manager-managed LLC and to general partners in a member-managed LLC.⁹⁹ All of the statutes address

or the director is found liable for a personal benefit improperly received. See MODEL BUSINESS CORP. ACT § 8.51(d) (1985). With respect to actions by or in the right of the corporation, indemnification is limited to reasonable expenses and excludes amounts paid to settle or satisfy claims. *Id.* § 8.51(e).

94. See *supra* notes 60-62 and accompanying text.

95. ULLCA § 1101.

96. *Id.* § 410(a).

97. One of those "other" factors will be the state income tax treatment of LLCs. See *infra* notes 250-54 and accompanying text.

98. For example, the LLC statutes in Alabama, Arizona, Kansas, Maryland, Nevada, South Dakota, Utah, and Wyoming do not express standards of conduct for members or managers. Several of the statutes do address dealings between members and the LLC. See, e.g., ALA. CODE § 10-12-19 (Supp. 1994) ("A member may lend money to and transact any lawful business with the limited liability company and, subject to other applicable law, have the same rights and obligations with respect thereto as a person who is not a member."); see also ARIZ. REV. STAT. ANN. § 29-608 (Supp. 1993); KAN. STAT. ANN. § 17-7613 (Supp. 1993); MD. CODE ANN., CORPS. & ASS'NS § 4A-405 (1993).

99. Keatinge et al., *supra* note 1, at 401 ("The [fiduciary duty] rule for LLCs probably will evolve toward general partnership-type duties for members in member-managed LLCs, and toward corporate director-type duties for managers in manager-managed LLCs."); see also Steven C. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43 (1994) (arguing that neither partnership nor corporate law is entirely appropriate and LLC law will probably be fashioned from a combination of concepts drawn from both). At least with respect to partnerships, the agency aspects play a significant role in creating the fiduciary obligations. See generally Vestal, *supra* note 13. In corporations too, controlling the discretion vested in one to act on behalf of another is part of the fiduciary relation. See DeMott, *supra* note 12, at 915. Several statutes expressly address the agency powers of managers and members. See, e.g., ALA. CODE § 10-12-21 (Supp. 1994) (agency power of members and managers); ARIZ. REV. STAT. ANN. § 29-654 (Supp. 1993) (member or manager as agent); KAN. STAT. ANN. § 17-7614 (Supp. 1993) (agency power of members and managers); MD.

the related issue of member or manager indemnification, but are inconsistent concerning such common issues as permitting indemnification when a manager has acted willfully or recklessly and whether the indemnity is limited to expenses of defense.¹⁰⁰

Assuming that fiduciary duties could be implied, could such duties be expanded, limited, or eliminated through the agreement of the parties? The contracting power of the members is crystallized in the operating agreement, but that power may not be absolute. The Alabama statute, for example, in describing the operating agreement, states that it "may contain any provisions regarding the affairs of an LLC and the conduct of its business that are not inconsistent with the laws of this State."¹⁰¹ Presumably the parties could create some semblance of fiduciary duties in their operating agreement; the ability to limit or eliminate fiduciary duties is the difficult question. One could assume that the governing "laws" referred to in the Alabama statute include common law and freedom of contract, as well as judicial oversight, public policy considerations, and the exercise of inherent equitable powers.¹⁰²

CODE ANN., CORPS. & ASS'NS §4A-401 (1993) (member as agent); UTAH CODE ANN. § 48-2b-125 (1994) (power of members or managers to bind the LLC). The Arizona statute expressly incorporates the law of agency and equity. *See, e.g.*, ARIZ. REV. STAT. ANN. § 29-854B (Supp. 1993) ("The law of estoppel and the law of agency apply to this chapter."); ARIZ. REV. STAT. ANN. § 29-856 (Supp. 1993) ("In any case not provided for in this chapter, the rules of law and equity, including the law merchant, govern.").

100. *See, e.g.*, ALA. CODE § 10-12-4(n) (Supp. 1994) (denying indemnification when the person is determined to be liable for negligence or misconduct but then permitting "any other indemnification that is authorized by the articles of organization, [or] the operating agreement"; the language apparently contemplates only expenses of defense but agreed upon terms might be broader); ARIZ. REV. STAT. ANN. § 29-610A. 13 (Supp. 1993) (power to "[i]ndemnify a member, manager, employee, officer or agent or any other person"; no apparent limitation on type of indemnity); KAN. STAT. ANN. § 17-7604 (j) (Supp. 1993) ("to the same extent as a corporation may indemnify any of the directors, officers, employees, or agents"); MD. CODE ANN., CORPS & ASS'NS § 4A-203(12) (1993) ("except in the case of action or failure to act . . . which constitutes willful misconduct or recklessness"; language extends to all claims or demands); NEV. REV. STAT. ANN. §§ 86.411, .421, .441, .451 (Michie 1994) (can include costs of settlement); S.D. CODIFIED LAWS ANN. § 47-34-25 (Supp. 1993) (precluding indemnification where person was liable for "negligence or misconduct in the performance of duty" but permitted "to make any other indemnification that is authorized by the articles of organization or by an article of the operating agreement"); UTAH CODE ANN. §§ 48-2b-105(1)(l), 48-2b-155 (1994) (indemnify "to the same extent that a partnership may indemnify any of the partners, managers, employees or agents of the partnership"; apparently limited to expenses of defense); *see also* UTAH CODE ANN. § 48-2b-155 (1994) (specifically addressing indemnification of manager for expenses in successfully defending a derivative action); WYO. REV. STAT. § 17-15-104(a)(xi) (Supp. 1994) (precluding indemnification if found "liable to the company for negligence or misconduct in the performance of duty or to have received improper personal benefit on account thereof" but permits "any other indemnification that is authorized by the articles of organization or by an article of the operating agreement").

101. ALA. CODE § 10-12-24(a) (Supp. 1994); *see also* ARIZ. REV. STAT. ANN. § 29-682B (1993) ("any provision that is consistent with law"); KAN. STAT. ANN. § 17-7613 (Supp. 1993) ("not inconsistent with the law"); S.D. CODIFIED LAWS ANN. § 47-34-1(6) (Supp. 1993) ("not inconsistent with the law"); UTAH CODE ANN. § 48-2b-126(3) (1994) ("any manner not inconsistent with law").

102. Even in the face of the seemingly exclusive listing of fiduciary duties by RUPA, Professor Vestal is unwilling to concede that the inherent equitable powers of the courts are ousted. *See Vestal, supra* note 13, at 532-33 n.24. Professor DeMott has suggested that potentially broad judicial intervention may be exercised through the process of interpreting the LLC contract. *See infra* note 155.

Thus, we return full circle to the contractarian/paternalist debate that I have largely reserved for others.¹⁰³ An even greater level of speculation exists in this inquiry because the issue of waiver is addressed before the fiduciary duty itself has been established. If the analogy is made to corporations, Professor DeMott and others have previously noted the general judicial hostility to exculpatory provisions in the context of corporate charters.¹⁰⁴ Her acceptance of that result is in part based on the dissimilarity of corporate charters and contracts, except perhaps in the closely held context.¹⁰⁵ The LLC is arguably different. Although there could be some potential use of LLCs for publicly traded vehicles, most people tend to view them as more appropriate for closely held enterprises.¹⁰⁶ Moreover, under the ULLCA at least, the mandatory provisions of the articles of organization are few and serve principally a notice function for third parties¹⁰⁷; the structure of the relationship is instead dictated by the operating agreement.

If a court applies a partnership analogy, the waivability of certain fiduciary duties would seem to be more certain, but even that conclusion is controversial. For example, Professor Ribstein has observed that courts have enforced partnership agreements "permitting partners to compete with the partnership and to engage in self-dealing,"¹⁰⁸ and he limits to their extreme facts several cases where exculpatory language was found inapplicable.¹⁰⁹ However, Professors Dickerson and Vestal disagree, and their view of the pre-RUPA law is that waivers of fiduciary duties were permissible only on a case-by-case basis.¹¹⁰

2. *No Express Standards But Express Authorization of Contractual Modifications.* The Delaware statute does not provide any manager or member standards of conduct and instead defers to the operating agreement.¹¹¹ The

103. See *supra* note 89.

104. See DeMott, *supra* note 12, at 921-23.

105. "Except in closely held corporations, the 'bargain' that a corporation's charter represents between its shareholders and directors is even more abstract: only rarely would shareholders know its content and even more rarely would they negotiate with the directors about that content." *Id.* at 923. On the other hand, one of the most widely cited decisions rejecting a charter provision permitting self-dealing was in the context of a closely held corporation. See *Irwin v. West End Dev. Co.*, 342 F. Supp. 687 (D. Colo. 1972).

106. See *infra* notes 219-43 and accompanying text.

107. See ULLCA § 203(a) (requiring LLC name, address of designated office, organizer's name and address, latest date for dissolution, and whether governance is by managers or members).

108. Ribstein, *supra* note 13, at 57.

109. *Id.* at 57 n.94.

110. See Dickerson, *supra* note 13, at 111 ("Partners may, however, believe that by mutual consent they can restrict or virtually eliminate these mutual obligations. Under current partnership law, this belief is probably mistaken; under most present judicial interpretations of the Uniform Partnership Act (UPA), fiduciary duties are mandatory provisions waivable only with informed consent, on a case-by-case basis."); see also Vestal, *supra* note 13, at 557.

111. See DEL. CODE ANN. tit. 6, § 18-306 (1993) (the limited liability company agreement may provide for specified penalties or consequences with respect to members upon events specified in the agreement); *id.* § 18-405 (same regarding managers).

New Jersey statute, which was patterned after the Delaware model,¹¹² adds a default provision establishing gross negligence or willful misconduct as the standard of care.¹¹³ The New Jersey statute also further enhances the stature of the operating agreement with respect to these matters by stating that “[t]he operating agreement may, in any event, eliminate or limit the personal liability of the [member or manager] for such failure to perform or to comply or for such other reason.”¹¹⁴

The drafters apparently anticipated that fiduciary duties might be implied by a court. Exalting freedom of contract,¹¹⁵ both statutes require only good faith reliance on the operating agreement and permit expansion or restriction of such duties (specifically mentioning fiduciary duties) and liabilities in the operating agreement.¹¹⁶

As might be said for most contractarian-influenced regimes, this approach is better suited for those with the resources to draft a comprehensive operating agreement.¹¹⁷

3. *Standards Prescribed But Silence as to Modifications.* At least two LLC statutes prescribe standards of conduct but do not address their modification.¹¹⁸ The standards refer to corporate law and would apparently introduce

112. Peter D. Hutcheon, *The New Jersey Limited Liability Company Statute: Background and Concepts*, 18 SETON HALL LEGIS. J. 111, 122 (1993) (“After considerable review, the working group concluded that the new Delaware act offered a better model for an LLC statute, although its very flexibility carried its own risks.”).

113. See N.J. STAT. ANN. § 42:2B-26 (West Supp. 1994) (member liability); *id.* § 42:2B-30 (manager liability).

114. *Id.* § 42:2b-26.

115. DEL. CODE ANN. tit. 6 § 18-1101(b) (1993) (“It 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.”); see also N.J. STAT. ANN. § 42:2B-66(a) (West Supp. 1994).

116. DEL. CODE ANN. tit. 6 § 18-1101(c) (1993) (“To the extent that, at law or in equity, a member or manager has duties (including fiduciary duties) and liabilities related thereto to a limited liability company or to another member or manager: (1) any such member or manager acting under a limited liability company agreement shall not be liable to the limited liability company or to any such other member or manager for the member’s or manager’s good faith reliance on the provisions of the limited liability company agreement, and (2) the member’s or manager’s duties and liabilities may be expanded or restricted by provisions in a limited liability company agreement.”); see also N.J. STAT. ANN. § 42:2B-66(b) (West Supp. 1994).

117. The Delaware and New Jersey statutes both required a written operating agreement. See DEL. CODE ANN. tit. 6, § 18-101(6) (1993); N.J. STAT. ANN. § 42:2B-2 (West Supp. 1994). In 1995, the Delaware statute was amended to permit oral agreements. See 70 Del. Laws c.75 § 3 (June 23, 1995). If the operating agreement fails to address fiduciary duties or to sanction conduct that would violate customary fiduciary duties, the statutory safe harbor of good faith reliance on the operating agreement would be of less comfort, because there would be no term on which to rely.

118. See, e.g., ILL. ANN. STAT. ch. 805, para. 180/10-10 (Smith-Hurd Supp. 1994) (creating liability of members or managers “to the extent that [a shareholder or director] of an Illinois business corporation is liable in analogous circumstances under Illinois law”); W. VA. CODE §§ 31-1A-20(h) (expressing a business judgment rule), 31-1A-33 (Supp. 1994) (members have the same rights and liabilities as do shareholders and managers have the same rights and liabilities as directors of corporations). The Ohio statute provides for a duty of care, and modification is not addressed. OHIO REV. CODE ANN. § 1705.29(B) (Baldwin 1994) (“A manager . . . shall perform his duties . . . in good faith, in a manner he reasonably believes to be in or not opposed to the best interests of the company, and with the care that an ordinarily prudent person in a similar position would use under similar

to those LLC acts the corporate law concerning modification of fiduciary duties.¹¹⁹

4. *Standards Prescribed as a Default Provision.* The ABA Prototype Limited Liability Act (the "ABA Prototype Act")¹²⁰ prescribes a gross negligence or willful misconduct standard of care for members or managers.¹²¹ It also provides a duty of loyalty, modeled after the Uniform Partnership Act, to account for any use of LLC property by a manager or member.¹²² The commentary to the ABA Prototype Act demonstrates the drafters' view that the courts could also import corporate fiduciary duties into the LLC.¹²³ However, the standards only serve a default role, and the operating agreement may eliminate or limit the personal liability of managers or members for monetary damages,¹²⁴ or possibly eliminate the duties altogether.¹²⁵ If the latter interpretation is correct and given literal application, actions alleging manager or

circumstances." The conduct provisions dealing with conflict of interests are, however, subject to the operating agreement. See OHIO REV. CODE ANN. § 1705.31 (Baldwin 1994).

119. See *supra* notes 104-10 and accompanying text.

120. Working Group on the Prototype Limited Liability Company Act, Subcommittee on Limited Liability Companies, Committee on Partnerships and Unincorporated Business Organizations, Section of Business Law, American Bar Association, Prototype Limited Liability Act (Nov. 19, 1992) [hereinafter "ABA Prototype Act"].

121. "Unless otherwise provided in an operating agreement: (A) A member or manager shall not be liable, responsible or accountable in damages or otherwise to the limited liability company or to the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes gross negligence or willful misconduct." *Id.* § 402.

122. "Every member and manager must account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one half by number of the disinterested managers or members, or other persons participating in the management of the business or affairs of the limited liability company, from (1) any transaction connected with the conduct or winding up of the limited liability company; or (2) any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the limited liability company or matters entrusted to the person as a result of his status as manager or member." *Id.* § 402(B). This language resembles Uniform Partnership Act § 21 that is the statutory basis for partnership fiduciary duties. See *id.* commentary § 402.

123. The ABA Prototype Act provides that unless provided otherwise in the operating agreement, "[o]ne who is a member of a limited liability company in which management is vested in managers . . . and who is not a manager shall have no duties to the limited liability company or to the other members solely by reason of acting in the capacity of a member." *Id.* § 402(C). The commentary suggests that (1) some members-to-members responsibilities exist, citing *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975), (2) members cannot steal LLC property, and (3) as contracting parties, the members must exercise their powers in good faith.

124. "An operating agreement may: (A) Eliminate or limit the personal liability of a member or manager for monetary damages for breach of any duty provided for in 402." ABA Prototype Act, *supra* note 120, § 404(A).

125. All of ABA Prototype Act § 402 is subject to the proviso "[u]nless otherwise provided in an operating agreement." As the commentary to section 404 notes, "consideration should be given to omitting subsection (A) [of section 404] as redundant of section 402." *Id.* commentary § 404. However, the conflict is much deeper than that. Section 404 permits an elimination or limitation of personal liability only for monetary damages. Arguably, the "[u]nless otherwise provided in an operating agreement" language of 402 would permit the complete elimination of the duty itself, as opposed to a limitation of the remedy. ABA Prototype Act § 1304(A) also repeats a rule of construction taken from the Delaware LLC act that "[i]t is the policy of this act to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."

member misconduct could be dramatically restricted, even if the desired remedy were limited to enjoining or setting aside the transaction.

Several states have adopted legislation patterned after the ABA Prototype Act.¹²⁶ The aspect of the Act that seemingly permits the elimination of liability for egregious misconduct has, in the case of the Arkansas statute, prompted criticism when compared to the prevailing rules for corporations and partnerships: "The section appears to sanction a provision eliminating liability even for willful misconduct by an LLC member or manager. No Arkansas limitation of liability provision has ever gone this far, and it is questionable whether such a provision could be supported on public policy grounds."¹²⁷

There are several LLC acts that do not use the language of the ABA Prototype Act but that do follow its opt-out approach to fiduciary duties, permitting contractual modification of those duties without limitation.¹²⁸

5. *Standards Prescribed and Limits Placed on Opting Out.* There is great variation in a number of the other LLC acts. Several states have adopted aspects of the ABA Prototype Act, but prohibit limitations of liability not only for intentional, willful, or criminal activities, but also for more uncertain categories such as "financial benefit . . . to which the member or the manager is not entitled."¹²⁹ The limitations often resemble those on director monetary

126. See, e.g., ARK. CODE ANN. §§ 4-32-402, 4-32-404, 4-32-1310(a) (Michie Supp. 1994); IDAHO CODE §§ 53-622, 53-624, 53-668(1) (1994); 1994 KY. ACTS 389 §§ 275.34, 275.36, 275.93.

127. Mary Elizabeth Matthews, *The Arkansas Limited Liability Company: A New Business Entity Is Born*, 46 ARK. L. REV. 791, 820 (1994).

128. See, e.g., Act of June 23, 1993, § 22, P.A. 93-267, reprinted in CONN. GEN. STAT. ANN. app. at 116 (West 1994) (specifying duties but not stating that the provision is subject to the terms of the operating agreement); Act of June 23, 1993, § 24, P.A. 93-267, reprinted in CONN. GEN. STAT. ANN. app. at 117 (West 1994) (permitting limitation or elimination of member or manager personal liability for monetary damages for breach of duty); Act of June 23, 1993, § 74(a), P.A. 93-267, reprinted in CONN. GEN. STAT. ANN. app. at 132 (West Supp. 1994) ("It is the policy of this act to give maximum effect to the principle of freedom of contract and to enforceability of limited liability company agreements."); N.M. STAT. ANN. §§ 53-19-16 (fiduciary duties section applies "[u]nless otherwise provided by the articles of organization or an operating agreement"), 53-19-65A (Michie Supp. 1994) ("It is the policy of the Limited Liability Company Act to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements of limited liability companies."); 1994 WA. ALS 211 §§ 402 ("[u]nless otherwise provided in the limited liability company agreement"), 405 (1994) (remedies for breach of the agreement by the managers can be specified—this resembles the Delaware act), 1301(2) (1993) ("It 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.");

129. See, e.g., IND. CODE ANN. §§ 23-18-4-2, 23-18-4-4 (Burns Supp. 1994) (the limitation of damages applies only to duties under 23-18-4-2(a), pertaining to willful or reckless misconduct, not to the loyalty provisions); MONT. CODE ANN. §§ 35-8-402 (resembling the ABA Prototype Act duties provision), 35-8-404 (1993) (precluding limitation of liability for "(a) the amount of a financial benefit received by a member or a manager to which the member or the manager is not entitled; (b) an intentional infliction of harm by the member or the manager on the limited liability company or its members; (c) an intentional violation of criminal law by the member or the manager; or (d) an unlawful distribution by the member or the manager"); N.H. REV. STAT. ANNOT. § 304-C:31 (Supp. 1993) (liability cannot be reduced for acts of "gross negligence or willful misconduct").

liability and indemnification that swept through corporate law following the Delaware Supreme Court decision in *Smith v. Van Gorkom*.¹³⁰

A number of statutes expressly address fiduciary duties using assorted manners of expression, but again, they all share a common trait in specifying certain behaviors for which liability is not waivable.¹³¹ Georgia, for example, is one of these jurisdictions. Its law states that “[n]o such provision shall eliminate or limit the liability of a member or manager: (i) For intentional misconduct or a knowing violation of law; or (ii) For any transaction for which the person received a personal benefit in violation or breach of any provision

130. 488 A.2d 858 (Del. 1985) (finding directors liable for damages that could exceed \$50 million in connection with their process of approving a merger transaction). Indiana was first to limit the personal liability of directors following the decision. See IND. CODE ANN. § 23-1-35-1(e) (1989). Delaware soon followed in limiting the monetary liability of directors, but “[s]uch provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) [for unlawful distributions]; or (iv) for any transaction from which the director derived an improper personal benefit.” DEL. CODE ANN. tit 8 § 102(b)(7) (1993). Director liability limitations continue to generate scholarly commentary. See, e.g., Deborah A. DeMott, *Limiting Directors’ Liability*, 66 WASH. U. L.Q. 295 (1988); Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Officer Liability*, 23 SETON HALL L. REV. 897 (1993); Dale A. Oesterle, *The Effect of Statutes Limiting Directors’ Due Care Liability on Hostile Takeover Defenses*, 24 WAKE FOREST L. REV. 31 (1989).

131. See, e.g., IOWA CODE ANN. §§ 490A.706, 490A.707 (West Supp. 1994) (cannot eliminate or limit liability for “1. Breach of the manager’s or member’s duty of loyalty to the limited liability company or to its members; 2. Acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; 3. Transaction from which the manager derives an improper personal benefit or a wrongful distribution”); LA. REV. STAT. ANN. §§ 12:1314, 12:1315B (Supp. 1994) (no exculpation for “a financial benefit received by a member or manager to which he is not entitled or for an intentional violation of criminal law”); MICH. COMP. LAWS ANN. §§ 450.4404, 450.4407 (West Supp. 1994) (no limitation for “(a) The receipt of a financial benefit to which the manager is not entitled; . . . (c) A knowing violation of law”); MINN. STAT. ANN. § 322B.663 (West Supp. 1994) (no limitation “(1) for any breach of the governor’s duty of loyalty to the limited liability company or its members; (2) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law . . . ; (4) for any transaction from which the governor derived an improper personal benefit”); N.C. GEN. STAT. §§ 57C-3-22, 57C-3-32 (1993) (no modification of liability for “acts or omissions that the manager knew at the time of the acts or omissions were clearly in conflict with the interests of the limited liability company, (ii) any transaction from which the manager derived an improper personal benefit”); NORTH DAKOTA CENT. CODE § 10-32-86 (Supp. 1993) (exceptions similar to those in the Minnesota act); OKLA. STAT. ANN. tit. 18, § 2017 (1994) (no limitation for breach of duty of loyalty, acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, or any transaction from which the manager derived an improper personal benefit); OR. REV. STAT. § 63.160 (1993) (no limitation for breach of manager’s duty of loyalty to the limited liability company or its members, acts of omissions not in good faith which involve intentional misconduct or a knowing violation of law, any unlawful distribution, any transaction from which the manager derives an improper personal benefit); R.I. GEN. LAWS §§ 7-16-17, 7-16-18 (1956, 1992 Reenactment) (similar to the Oregon exclusions); TENN. CODE ANN. § 48-239-115(d) (Supp. 1994) (manager’s liability cannot be eliminated or limited for breach of duty of loyalty, acts or omissions not in good faith or for intentional misconduct or knowing violation of law); VA. CODE ANN. §§ 13.1-1024.1, 13.1-1025 (Michie 1993) (statutory limitation of monetary liability not applicable to willful misconduct or a knowing violation of the criminal law); WIS. STAT. ANN. § 183.0402 (West Supp. 1994) (stating general rules unless otherwise provided in operating agreement, but then permitting only expansion of those duties, and “not in abrogation of” them, with respect to willful failure to deal fairly with the LLC in a matter in which the member or manager has a material conflict of interest, violation of criminal law, derivation of improper personal profit, and willful misconduct).

of a written operating agreement.”¹³² This approach reportedly was followed to create certainty through a resemblance to standards for general partners of limited partnerships and corporate directors.¹³³

6. *A Clear Divergence In Approach.* The Delaware statute, with its absence of any default rules and emphasis on freedom of contract, is in sharp contrast to the RUPA-influenced approach of the ULLCA. The ABA Prototype Act prescribes default rules but is otherwise very amendable. The ULLCA is a compromise, providing default rules but also constraining the free contracting approach. While a majority of the state LLC statutes permits members to tailor their agreements with respect to fiduciary issues, many specify core acts or omissions for which liability cannot be diminished. This sharp divergence in approach could ultimately be one of the factors creating interstate competition for LLC charters, or at least a continuing lack of uniformity in law, a topic discussed later in this paper.

C. Proposing Standards

One aspect of the RUPA fiduciary duty debate is comparative. Both sides of the debate argue that something has been lost: either freedom to contract around certain aspects of fiduciary duty has been restricted,¹³⁴ or the scope of fiduciary duties has been limited.¹³⁵ In part, the arguments are against changes that would unsettle years of judicial development of the law of partner fiduciary duty. Unless one is ready to make the argument that as a matter of function an LLC is simply a partnership with limited liability for all, there is no developed LLC law to be replaced. Although the LLC is similar to the general partnership in many respects aside from the limited liability factor, the analogy is weakened by the greater range of the LLC. It can function in an intimate general partnership or close corporation¹³⁶ manner, as well as in a limited partnership or corporate context with a greater separation of ownership and

132. GA. CODE ANN. § 14-11-305(4)(A) (1994).

133. Charles R. Beaudrot, Jr. & Kendall Houghton, *Effective Use of Limited Liability Companies in Georgia: An Overview of Their Characteristics and Advantages*, 45 MERCER L. REV. 25, 34 (1993) (“The drafters thought that any attempt to further limit the duties of members or managers of an LLC might be held to be contrary to public policy and would force the courts to develop an ad hoc response through responding to unnecessary litigation. By adopting this well understood standard, the courts should be dissuaded from creating more open-ended standards through resolving litigation.”).

134. See generally Ribstein, *supra* note 13.

135. See generally Vestal, *supra* note 13.

136. The most common example of a competing analogy is to the corporation with respect to extending the doctrine of “piercing the veil” to LLCs. See *supra* note 4. Because of the similarity to closely held corporations, other analogies, concerning fiduciary duties, for example, might be made. See generally Bahls, *supra* note 99.

management.¹³⁷ In determining what fiduciary standards are appropriate, an appreciation of the broad spectrum of LLC management scenarios is needed.

1. *Variations in LLC Management Structures.* Under many LLC statutes and the ULLCA, managers need not be members.¹³⁸ Theoretically, one could more easily dismiss such managers, like corporate officers, because one need not also deal with disposition of a substantial proprietary stake.¹³⁹ This scenario departs from the general or limited partnership management structure in which a partner will own some proprietary stake, albeit a modest one. On the other hand, partnerships permit incorporated partners, and many LLC statutes and the ULLCA likewise allow managers that are not individuals.¹⁴⁰ In comparison, corporate directors must be individuals.¹⁴¹ These peculiarities aside, there are at least five distinct LLC management scenarios, each with differing LLC statutory responses.

First, the managers could not be members at all. In this situation, the managers would largely resemble corporate officers and outside directors.¹⁴² Corporate style fiduciary duties, with respect to both care and loyalty, would seem appropriate.¹⁴³ The ULLCA would apply partnership style duties to this situation.¹⁴⁴ With respect to the members themselves, the ULLCA states that

137. Of course, some general partnerships, like large accounting, financial, or legal services enterprises, can operate with a very centralized management structure. Arthur Andersen & Co., for example, reportedly has 2,500 partners in 72 countries. See *Partners in Pain*, 132 *ECONOMIST* 61, at 62 (Jul. 9, 1994).

138. See ULLCA § 101(11).

139. If, however, the manager were also a member, then an ownership stake resembling a partnership interest would need to be addressed. Professor Bahls argues that in that instance, the standard of duty should be high because of the difficulty of removing the manager. See Bahls, *supra* note 99, at 75. This ignores the impact of employment severance packages even in the absence of an equity position.

140. See, e.g., ULLCA § 101(11) ("manager" means any person); *id.* § 101(15) ("person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government, governmental subdivision, agency, or instrumentality, or any other legal or commercial entity").

141. See, e.g., MODEL BUSINESS CORP. ACT § 8.03(a) (1985) ("A board of directors must consist of one or more individuals . . .").

142. The analogy to corporate directors is not completely appropriate under most LLC statutes. Most LLC statutes provide only for managers who provide for the day-to-day management of the LLC, like corporate officers, but who also make fundamental policy decisions like corporate directors. Although inside corporate directors are usually officers, an outside director does not manage the daily affairs of the corporation and has little agency authority. The Minnesota LLC statute is almost unique in designating "governors," who resemble directors, and "managers," who resemble corporate officers. Recent amendments to the Delaware Limited Liability Company Act added a new section 18-407 that permits the delegation of manager or member authority to a third person who may be designated as an officer. See Paul M. Altman & James G. Leyden Jr., *1994 Amendments of the Delaware Limited Liability Company Act*, 8 *INSIGHTS* 28 (Oct. 1994).

143. The Oregon LLC statute prescribes a manager's standard of care that resembles that of corporate officers and directors. See OR. REV. STAT. §§ 60.357, 60.377 (1993). The corporate standard was chosen because "unlike partners in the general partnership context, managers are not personally liable for the obligations of the LLC. Thus, protection from personal liability is not an incentive to act prudently." David L. Cameron, *Strike Up the Band: The Limited Liability Company Comes to Oregon*, 30 *WILLAMETTE L. REV.* 291, 310 (1994).

144. See *supra* notes 80-96 and accompanying text.

“a member who is not also a manager has no duties to the company or to the other members solely by reason of being a member.”¹⁴⁵ This language was not derived from RUPA because general partnerships do not have a manager concept. Apparently it was adopted from the ABA Prototype Act, and commentary suggests that it does not exclude duties of controlling members.¹⁴⁶

Under a second alternative, the managers could all be members and represent all, or a majority, of the member interests. General-partner-style fiduciary duties of care and loyalty would seem appropriate, even in the absence of general liability for entity obligations. In this situation, the ULLCA would again apply its partnership-style fiduciary duties. It is predictable that this approach would not be universally adopted. The Illinois LLC act, for example, provides that the liability of members and managers is that of shareholders or directors of a corporation.¹⁴⁷ Some commentators have criticized the practicality of this rule as applied to the closely held LLC:

Because most LLCs will likely be closely held, however, such a provision may not be effective in solving the specific problems which may arise in the typical LLC environment. For example, a corporate transaction in which a director has a conflict of interest is valid if approved by a majority of disinterested shareholders or directors after full disclosure of the conflict. The closely held character, which will presumably become typical of LLCs, indicates that truly disinterested members or managers will rarely exist.¹⁴⁸

In response to this issue, the ULLCA permits the operating agreement to “specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.”¹⁴⁹

In the third situation, there could be no managers, and all of the members would govern as members. General partner-style fiduciary duties would once again appear to be appropriate, and the ULLCA applies the RUPA-influenced standards of conduct.¹⁵⁰

In the fourth situation, the managers could be members but would represent a minority of the member interests. This structure could arise under “promoter” circumstances. The fiduciary duties of a general partner of a limited partnership or a corporate officer or director could be appropriate.¹⁵¹ The

145. ULLCA § 409(h)(2).

146. See *supra* note 123.

147. See ILL. ANN. STAT. ch. 805, para. 180/10-10 (Smith-Hurd Supp. 1994).

148. Anderson, *supra* note 3, at 93. “In contrast, because an LLC is likely to be closely held, none of the managers will be ‘disinterested.’ It is reasonable to expect, therefore, that the rule that will emerge in the LLC context will require consent by all members to each conflict transaction in the absence of contrary agreement.” Keatinge et al., *supra* note 1, at 391.

149. ULLCA § 103(b)(2)(ii). Compare ULLCA § 404(c)(2) (otherwise requiring the consent of all members to ratify actions that would breach the duty of loyalty).

150. See *Id.* §§ 409(a) (imposing a duty of loyalty and a duty of care), 409(d) (member shall discharge duties and exercise rights consistently with the obligation of good faith and fair dealing), 409(e) (member does not violate duty or obligation merely because member’s conduct furthers the member’s own interest), 409(f) (a member may lend money to and transact business with the LLC).

151. With respect to fiduciary duties, RULPA prescribes the same duty for the general partner as in a partnership without limited partners. RULPA § 403(a) (“Except as provided in this [Act] or in

ULLCA approaches that result by holding the managers in that case to partnership style duties. However, the nonmanager members would be subject only to those duties discussed in the first situation above.

The last alternative is a combination of manager and member management. The LLC would have managers, but certain decisions would be reserved to the members. Under these conditions, the ULLCA places fiduciary duties on the members and releases the managers from liability with respect to the specific acts in question.¹⁵²

2. *No Express Standards.* In view of the developing nature of the LLC, it might be argued that the ULLCA is premature in specifying fiduciary duties and doubly so in specifying unwaivable duties. Unlike the partnership and corporation that have the benefit of years of judicial and practitioner experience, the ULLCA approach arguably stifles healthy experimentation. An alternative would be to let the judiciary develop the law, adapting it to the varying circumstances that present themselves. That path was the one generally taken by partnership and corporate fiduciary law¹⁵³ and is essentially the approach of several state statutes.¹⁵⁴ However, to open the LLC to years of judicial experimentation just because the partnership and corporate law took that path is unwise; the LLC statutes should reflect those experiences without

the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners.”); see also ULPA § 9(1) (“A general partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners . . .”). The traditional limited partnership, with passive limited partners, closely resembles a manager-managed LLC. RUPA aside, there is substantial judicial guidance concerning the nature of the general partners’ fiduciary duties to the limited partnership and limited partners. A number of decisions speak in the familiar language of a duty of “utmost good faith and loyalty.” See, e.g., *Fowler v. Brignoli*, 765 F. Supp. 1202, 1205 (S.D.N.Y.), *aff’d*, 952 F.2d 393 (2d Cir. 1991); see also *Palmer v. Fuqua*, 641 F.2d 1146 (5th Cir. 1981) (sole general partner of a limited partnership owes even greater duty to limited partners than is normally imposed on partners); *Nashville City Bank and trust Co. v. Massey*, 540 F. Supp. 566, 578 (M.D. Ga. 1982) (“scrupulous good faith and candor”); *Preston v. Granada Mgmt. Corp.*, 470 N.W.2d 411 (1991) (applying Texas law which compares the general partner to a trustee); *Glanzer v. St. Joseph Ind. School*, 438 N.W.2d 204, 211 (S.D. 1989) (“loyalty of the highest order”); *Ebest v. Bruce*, 734 S.W.2d 915 (Mo. App. 1987) (relationship of trustee to the trust beneficiaries). Some opinions compare the duties to those of a corporate director. See, e.g., *Miller v. Schweickart*, 405 F. Supp. 366 (S.D.N.Y. 1975); *Brooke v. Mt. Hood Meadows Oreg., Ltd.*, 725 P.2d 925 (Or. Ct. App.), *aff’d on reh’g*, 732 P.2d 36 (Or. Ct. App. 1986). Others specifically apply a business judgment rule to the actions of partners. See, e.g., *Shlomchik v. Richmond 103 Equities Co.*, 662 F. Supp. 365 (S.D.N.Y. 1986) (business judgment made in exercise of good faith); *Shinn v. Thrust IC, Inc.*, 786 P.2d 285 (Wash. Ct. App. 1990) (on the facts the general partners did not satisfy the business judgment rule); *Wyler v. Feuer*, 149 Cal. Rptr. 626 (1978) (general partner not liable for actions in good faith exercise of reasonable business judgment).

152. See *supra* notes 80-84 and accompanying text.

153. For example, until 1974 the Model Business Corporation Act had no section defining the duties of directors and officers. See HARRY G. HENN & JOHN R. ALEXANDER, *LAWS OF CORPORATIONS* § 232 (1983).

154. See *supra* notes 98-110 and accompanying text.

repeating them. Prescribing some standards does not necessarily suggest an inflexible strait jacket.¹⁵⁵

3. *Express Duty of Care.* Even assuming that the RUPA formulation of fiduciary duties will prove appropriate for partnerships, one must further assume that the partnership form is similar enough to the LLC to support the ULLCA's direct adaptation of those standards. The unlimited liability of general partners, which differs from the limited liability of the LLC members and managers, has been suggested as already providing a restraint on their actions, justifying a lower standard with respect to the duty of care.¹⁵⁶ A counterargument for a stricter standard in the general partnership context, based on the potential harm in terms of the personal liability exposure of the other partners,¹⁵⁷ also does not apply to the LLC. Nevertheless, the ULLCA reliance on the partnership model in prescribing the duty of care is probably appropriate for member-managed LLCs, in terms of owner and manager alignment of interests, rather than personal liability exposure.

In a manager-managed LLC, the circumstances are somewhat different. Yet, if the managers themselves are not members, or have a smaller interest in the LLC than most of the members, the partnership gross negligence standard may still be an appropriate starting point in light of the members' power to refine the standard in their operating agreement. First, the interests of the managers might not be aligned with those of the members; the managers could be overly cautious because they could be liable for breach of an ordinary negligence standard of care, while the members could lose only their investment in the LLC.¹⁵⁸ Second, on a strictly comparative basis, if a manager-managed LLC is similar to a limited partnership or a more widely held corporation, the standards of care for both of those entities already approach a willful or gross

155. As Professor Coffee has observed with respect to corporate provisions, the judiciary will play a significant role in any statutory scheme. See generally John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989). Professor DeMott has persuasively argued that even in a contractarian LLC world along the lines of the Delaware statute, the uncertainty of judicial intervention may still not be avoided due to the potential application of contract doctrines, like an implied covenant of good faith and fair dealing and the need for interpretation of incomplete writings. See Deborah A. DeMott, *Fiduciary Preludes: Likely Issues for LLCs*, 66 U. COLO. L. REV. (forthcoming 1995).

156. Keatinge et al., *supra* note 1, at 398; see also Cameron, *supra* note 143 ("Because general partners are personally liable for business debts, there may not be a need to discipline them through liability for negligent management.").

157. Professor Bahls argues that the standard for a general partnership should instead be high, because, due to unlimited liability, all of the partners have more at risk for poor decisions. See Bahls, *supra* note 99, at 76. This, of course, assumes that the partners are not in turn incorporated entities.

158. Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1424 (1989) ("When managers hold the stock of their firm, they are 'bonding' their performance (in part) by exposing their wealth to erosion if their performance, and hence the firm's profits, is substandard."). Some might also make the corporate argument that due to the unaligned interests, one would need to offer a reduced standard of care to attract managers lacking significant proprietary stakes. Furthermore, the more widely held the LLC becomes, the greater are the diversification opportunities for the members, so less emphasis should be placed on the duty of care with respect to a single investment.

negligence standard, particularly with the overlay of the business judgment rule.¹⁵⁹

4. *Express Duty of Loyalty.* The ULLCA adopts the RUPA standards of loyalty and good faith and fair dealing.¹⁶⁰ Putting aside the question of whether the RUPA standards themselves are appropriate for partnerships, the recurrent theme again is whether partnership attributes are appropriate for the LLC. Because of the potential for a number of management structures, none of the analogies, whether to general partnerships, limited partnerships, or closely held corporations, perfectly fits the LLC. However, partnership-style duties will probably work as well as any. First, at least for member-managed LLCs, the partnership analogy is close. Although there may be manager-managed LLCs that depart from the model, more LLCs may tend to be member-managed. Second, in any event, if one is comparing the fiduciary duties applicable to general partnerships, limited partnerships, and closely held corporations, there are more similarities than differences; as a reasonably close fit, partnership-style fiduciary duties are probably appropriate as a starting point.¹⁶¹ Third, the

159. For the standard of care for general partners of limited partnerships, see *supra* note 151. A typical expression of a corporate standard of care is "care an ordinarily prudent person in a like position would exercise under similar circumstances." MODEL BUSINESS CORP. ACT § 8.30(a)(2) (1985). With the overlay of the business judgment rule and statutes exculpating directors for personal liability, the apparent simple negligence standard in application approaches a willful or reckless standard. No matter how aggressively one would want managers to act, one presumably would want them to at least act along the lines of the ULLCA guidelines (with gross negligence perhaps as an exception) at a minimum, to eschew "intentional misconduct, or a knowing violation of law." ULLCA § 409(c). One would assume that one would not want them to act "not in good faith . . . [or with] intentional misconduct or a knowing violation of law." With respect to the previous sentence, the reader probably recognizes the similarity to the exclusionary language from the Delaware Corporate Code. See DEL CODE ANN. tit. 8, § 102(b)(7) (1993). There are a number of other formulations of the concept, in corporate law. The American Law Institute Principles of Corporate Governance Project would not permit a limitation on damages for "knowing and culpable violation of law . . . conscious disregard for the duty . . . under circumstances in which the director or officer was aware that the conduct or omission created an unjustified risk of serious injury to the corporation; or . . . a sustained and unexcused pattern of inattention that amounted to an abdication of . . . duty to the corporation." AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 7.19 (Tentative Draft No. 11, Apr. 25, 1991). The concept also predominates in existing LLC legislation. The ULLCA phrase "intentional misconduct" is troubling somewhat, from the standpoint of uncertain interpretation, but the parties could refine the term in their agreement, subject to the overall limitation that such modifications not "unreasonably reduce the duty of care." ULLCA § 103(b)(3).

160. See *supra* notes 80-96 and accompanying text.

161. Corporate law is much more structured in dealing with conflict of interest procedures. See, e.g., MODEL BUSINESS CORP. ACT §§ 8.60-8.63 (1985). The ULLCA permits contractual agreement concerning standards for approving conflict of interest transactions. See *supra* notes 85-91 and accompanying text. Because of the difficulties of exit from the closely held corporation, as compared with the dissolubility of at least the general partnership, there is more corporate law speaking to "oppression" of minority shareholders. Several commentators have observed that fiduciary standards are more rigorously applied to partnerships than in the context of closely held corporations. See generally Dickerson, *supra* note 12 (asserting that closely held corporation law has become contractarian, and arguing that view of fiduciary duty should not be extended to the partnership); Mitchell, *supra* note 2 (arguing that fiduciary standards as applied by the courts to close corporations require affirmative bad faith or intentional misconduct rather than a broader inquiry into the beneficiary's best interests).

allowable modifications by the parties themselves and by judicial interpretations will hopefully provide the moderating influence to make the fit more perfect for the LLC. This last point, flexibility, is therefore important in considering models such as the ULLCA.

5. *The Limits on Flexibility.* As discussed previously, both the Delaware LLC Act and the ABA Prototype Act apparently permit the complete elimination of fiduciary duties,¹⁶² which is in contrast with the ULLCA approach.¹⁶³ This difference among the LLC statutes revisits the debate over RUPA and the limits of freedom of contract, a topic fully discussed elsewhere in this symposium.¹⁶⁴ Many of the same arguments apply to the LLC. On the one hand, the close relationship of members in a member-managed LLC should support fuller knowledge of, and bargaining about, the pertinent fiduciary duties.¹⁶⁵ On the other hand, with manager-managed LLCs and passive members, one could find the absence of *both* an intimate relationship among the members and an active market with its information dissemination function.¹⁶⁶ In the strict contractarian view, everything can be negotiable, and the duty of loyalty should be on the table. However, it has been conceded that parties would have to be crazy to bargain loyalty away, because it would create a license to steal.¹⁶⁷ Professor Black uses the duty of loyalty as an example of a “market mimicking” rule that everyone would want anyway.¹⁶⁸

Even if a fiduciary duty of “loyalty” is desirable, the problem of defining “loyalty” to everyone’s satisfaction is the challenge. Heretofore, the concept was developed through litigation. That approach is uncertain, costly, and can produce disputes and litigation that may be unfounded.¹⁶⁹ Accordingly, one must draw the fine line between permitting the parties to agree upon the

162. See *supra* notes 111-17, 120-28 and accompanying text.

163. See *supra* notes 80-96 and accompanying text.

164. See *supra* note 89.

165. Easterbrook & Fischel, *supra* note 12, at 284 (“Certainly participants in closely held corporations are better informed about their legal rights and obligations than participants in either partnerships or public corporations. Investors in close corporations often put a great deal of their wealth at stake, and the lack of diversification (compared with that of investors in publicly held firms) induces them to take care.”).

166. Easterbrook & Fischel, *supra* note 158, at 1435 (“[P]articipation in corporations is uniquely amenable to contracting because even the ignorant have an army of helpers. The stock market is one.”).

167. Roberta Romano, *Answering the Wrong Question: The Tenuous Case For Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1601 (1989) (“But the hypothetical, eliminating the duty of loyalty, is too incredible to be seriously entertained: what says shareholders would agree to license theft?”).

168. See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 553 (1990).

169. This depends upon one’s perspective. Professor Mitchell, a proponent of strong fiduciary duties, considers uncertain standards as desirable: “The very ambiguity of the language conveys its moral content as the court’s refusal to set lines is designed to discourage marginal conduct by making it difficult for a fiduciary to determine the point at which self-serving conduct will be prohibited, and thus to encourage conduct well within the borders.” Mitchell, *supra* note 2, at 1696 (commenting on *Meinhard v. Salmon*, 249 N.Y. 458 (1928)). Professor Vestal has argued that the RUPA fiduciary duty provisions’ “Anti-Litigation Bias” is more a pro-defendant bias. See Vestal, *supra* note 13, at 544 n.79.

meaning of loyalty under their circumstances and not permitting the elimination of the duty. This seems to be contradictory, that we trust the contracting process for the most part, and assume bargaining and adequate information, but do not trust it enough to completely eliminate the duty.¹⁷⁰

This apparent contradiction may reflect the difficulty in defining the role of fiduciary duty, except in a contextual setting.¹⁷¹ Furthermore, although one may successfully anticipate and delineate many of the concerns, limiting potential future disputes in the process, a strict “organizational documents” view of fiduciary duty ignores the ongoing, evolving nature of the business relationship as contrasted with other relationships, such as those between debtors and lenders. A number of potential self-dealing situations are practically unavoidable, and the parties should be able to limit uncertainty with respect to them. For example, the LLC could lease office space or other assets from a member, and a member could provide management, administrative, or research services to the LLC. Establishing the contract terms or parameters would not seem “manifestly unreasonable.” Competing business opportunities present a more difficult issue. With a real estate business, for example, it is not unusual for the parties to agree on a radius clause for competing properties.¹⁷² Intangible property businesses, like investment companies, present the issue of whether all potential opportunities meeting the investment criteria must be presented to the company. It would seem that limitations in this regard would not be “manifestly unreasonable.”¹⁷³

170. As Bernard Black has noted,

giving close corporations the power to dispense with the duty of loyalty would be troublesome. Given the opportunity, some close corporation investors will trust their co-investors or, more likely, won't consider the issue. The casebooks are full of situations where such trust proved to be misplaced, despite an explicit statutory duty. If we make the statutory duty optional, instances of abuse will likely increase. Close corporation investors also will often lack the base of experience to envision the many ways that conflict may arise over a long time period, and this may misvalue fiduciary protections.

Black, *supra* note 168, at 572. “The contractarian formulation jeopardizes unsophisticated participants, inadvertent partners, partners with insufficient resources to retain counsel and enter into lengthy negotiations, and individuals with inadequate experience to appreciate the problem.” Vestal, *supra* note 13, at 541.

171. DeMott, *supra* note 12, at 879 (“Although one can identify common core principles of fiduciary obligation, these principles apply with greater or lesser force in different contexts involving different types of parties and relationships. Recognition that the law of fiduciary obligation is situation-specific should be the starting point for any further analysis.”).

172. If of like quality and character, the properties will compete for many of the same tenants.

173. This language was adapted from the Uniform Commercial Code. See *supra* notes 88, 91. Much of the case law involves creditor transactions and is not altogether useful in this context. However, the case law is somewhat instructive in distinguishing broad exculpatory language pertaining to an issue from language defining one's standard of conduct. For example, it could be an invalid disclaimer to state that a party has no liability arising with respect to matters of notice. On the other hand, the same court could uphold a provision in which it is clear that a party has no contractual duty to give certain notices in certain situations. Given the propensity for broad exculpatory language in many loan documents, the distinction is often murky. Compare *Congress Fin. Corp. v. Sterling-Coin Op Mach. Corp.*, 456 F.2d 451 (3rd Cir. 1971) (holding that attempted exculpation for any omission or failure or neglect with respect to filing a document was an exculpation, not a definition of a standard of care); *Mercantile Stores Co. v. Idaho First Nat'l. Bank*, 641 P.2d 1007 (Idaho Ct. App. 1982) (holding that

However, there is the underbelly, where much of the fiduciary law has been developed. For example, consider the manager who sells the LLC properties to a straw person, at an agreed upon, but less than fair market value price, who then re-sells them for a built-in profit.¹⁷⁴ Alternatively, in negotiating for the purchase of a member's LLC interest, the manager does not disclose the existence of an offer to purchase the LLC assets at a high price.¹⁷⁵ Whether one views fiduciary duty as a simple contractual "gap filler"¹⁷⁶ or as a restraint on opportunistic behavior by a person in a position of dominance,¹⁷⁷ the parties would not have hypothetically agreed upon such an extreme term, nor would they have spelled it out in advance. An LLC organizer, seeking maximum flexibility, and perhaps, if the opportunity presents itself, a "license

agreement that bank could honor facsimile signatures did not extend to hand-traced facsimiles created by an embezzler-employee); *Toomey Equip. Co. v. Commercial Credit Equip. Corp.*, 386 So. 2d 1155 (Ala. Civ. App. 1980) (holding that notice of impairment of collateral not waived by general language which would otherwise amount to an exculpatory clause) *with* *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129 (5th Cir. 1979) (holding that parties could agree that termination of an agreement "for any reason" would not constitute bad faith); *Kearney State Bank & Trust Co. v. Scheer-Williams*, 428 N.W.2d 888 (Neb. 1988) (upholding waiver of notice of foreclosure sale in context of loan workout and holding that borrowers waived all right to such notification); *Brodheim v. Chase Manhattan Bank*, 347 N.Y.S.2d 394 (N.Y. Sup. Ct. 1973) (holding that pledgee of bonds had no liability for failing to notify pledgor of conversion call when expressly referred to in the loan agreement).

174. Disclosure is at the heart of many fiduciary cases. *See, e.g., Fleck v. Cablevision VII, Inc.*, 763 F. Supp. 622 (D.D.C. 1991) (holding that failure to adequately disclose the value of partnership assets in purchasing limited partner interests stated a claim of breach of fiduciary duty by the general partner); *Appletree Square I Ltd. Partnership v. Investmark, Inc.*, 494 N.W.2d 889 (Minn. Ct. App. 1993) (holding that general partners who sold building to limited partnership had duty to disclose information concerning possible asbestos contamination); *Band v. Livonia Assoc.*, 439 N.W.2d 285 (Mich. Ct. App. 1989) (holding that disclosure by general partners to some limited partners of the amount of profit made on a sale of property to the partnership was insufficient). Limitations of fiduciary duties in the partnership agreement have been upheld by the courts, provided that their often general language applies to the situation in controversy. *See, e.g., Silverman v. Weil*, 662 F. Supp. 1195 (D.D.C. 1987) (holding that general partner's negligent activities did not rise to the fraud or willful misconduct standard provided in the partnership agreement), *aff'd*, 839 F.2d 824 (D.C. Cir. 1988); *Atkins v. Rustic Woods Partners*, 525 N.E.2d 551 (Ill. App. Ct. 1988) (holding that arbitration clause in partnership agreement extended to disputes as to whether general partner breached fiduciary duties). On several occasions, language in the partnership agreement has not been given an exculpatory interpretation by the courts. *See, e.g., Appletree Square I Limited Partnership*, 494 N.W.2d at 893 (holding that provision that general partners would "provide the partners with all information that may reasonably be requested" did not eliminate duty to disclose facts about possible asbestos contamination); *Labovitz v. Dolan*, 545 N.E.2d 304 (Ill. App. Ct. 1989) (holding that provision in partnership agreement that gave general partner discretion to distribute cash as appropriate was still subject to a fiduciary duty of fairness, honesty, good faith, and loyalty to the limited partners); *Bassan v. Invest Exchange Corp.*, 524 P.2d 223 (Wash. 1974) (holding general partner accountable for profits on sale of land to partnership because the arrangement was not consented to in the partnership agreement).

175. *See, e.g., Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988). One of the criticisms of the RUPA approach to fiduciary duty is that the duty to disclose such matters may have been attenuated. *See Vestal, supra* note 13, at 546-49.

176. Easterbrook & Fischel, *supra* note 12, at 291 ("Fiduciary duties serve as implicit standard terms in contractual agreements that lower the cost of contracting. Properly interpreted, fiduciary duties should approximate the bargain the parties themselves would have reached had they been able to negotiate at low cost.").

177. Demott, *supra* note 12, at 915 ("Described instrumentally, the fiduciary obligation is a device that enables the law to respond to a range of situations in which, for a variety of reasons, one person's discretion ought to be controlled because of characteristics of that person's relationship with another.").

to steal," probably could not foresee everything that he or she would like to do, and even if so perfectly prescient, he or she could not "sell the deal" if the details of everything planned were in fact clearly spelled out. It is easier to disclaim completely all duties in a numbing blast of generalized boilerplate than to try to describe what is to be done.¹⁷⁸

The ULLCA approach is not perfect in this regard; owing to its RUPA roots, it is a compromise between extremes. However, in further deference to the importance of contractual freedom, with respect to the duty of loyalty, the ULLCA permits the parties to specify the number or percentage of members or disinterested managers that may authorize or ratify a specific action.¹⁷⁹ The parties apparently are not bound to any number or percentage, and the overall proviso that limitations not be "manifestly unreasonable" does not appear to apply to this provision. This adds even greater flexibility to the ULLCA provisions than is possible under RUPA.

V

THE ENDANGERED SPECIES LIST: DETERMINING THE BOUNDARIES OF THE REVOLUTION

The speed of the LLC's rise as a new business entity is perhaps unprecedented. The effects on other choices of entity will ripple through the legal environment as legislators, practitioners, judges, and businesspersons gain familiarity with the strengths and weaknesses of the new entity. Although background factors never remain fixed for significant periods of time, some of the competing forms would otherwise become obsolete for newly formed enterprises, and to a lesser extent for established enterprises.¹⁸⁰ A brief look at the competition is relevant. If the other forms are in fact facing obsolescence, pressures for change may be created in those entities in the areas in which the LLC is superior. Of equal significance, the nature of the parties who are abandoning the other entities may tell us something about those who may use the LLC and the types of pressures they will likely bring to the legislative process. In that regard, it is my view that alterations to the S corporation and limited partnership would have provided a lower cost alternative than adopting a new and

178. In dealing with disclaimers, Professor Eisenberg approaches this issue from the standpoint of investor comprehension rather than the promoter's drafting challenge. He argues that the investor cannot foresee the circumstances in which a waiver will be applicable and generally does not understand the risks. See Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1465-66, 1469-70 (1989).

179. See *supra* notes 147-49 and accompanying text.

180. Although many LLC statutes permit mergers into LLCs from dissimilar entities, the Internal Revenue Code is an impediment to midstream conversions to LLC status, particularly if the company is a corporation. This issue is beyond the scope of this paper. In general the easiest cases will be conversions from general or limited partnerships because both the converting entity and the LLC will be considered "partnerships" for federal income tax purposes. The conversion of both C and S corporations would usually involve, to some degree, a liquidation or other taxable disposition of the assets of the corporation and in that regard could have adverse consequences.

untested entity. The LLC, however, bypassed that gridlocked process and pressed the issue. It is too late to turn back the clock. However, with respect to publicly traded corporations in particular, limits may need to be imposed to permit further study of the desirability of highly flexible, publicly traded LLCs.

A. The General Partnership

It is probably not useful to compare general partnerships and LLCs from a planning perspective; if the participants do engage in any planning, the desirability of limited liability will be so significant for most enterprises to answer the question decisively in favor of the LLC.¹⁸¹ While the LLC may be a trap for the unwary, particularly in view of the untested state of the law, the statutory resemblance to general partnership¹⁸² may be a blessing. If the LLC operating agreement is only rudimentary, the ULLCA's similarity to RUPA in its default provisions would tend to produce roughly similar results to a similarly situated partnership.

A complete discussion of the "limited liability partnership" or "registered limited liability partnership" (jointly "LLP") is beyond the scope of this article. However, those developments address one of the factors propelling the LLC, the rush toward limited liability havens. In limiting the liability of general partners, but as an overlay on the well-known partnership law foundation, such legislation could produce renewed interest in the general partnership. Some of the LLP statutes apply only to partnerships of persons rendering professional services.¹⁸³ Others restrict the protection to limiting personal liability for the negligence of copartners, without affecting liability for other obligations of the partnership.¹⁸⁴ LLP amendments to the general partnership laws that limit liability for all types of activities and for all partnership obligations,¹⁸⁵ if adopted by a number of states,¹⁸⁶ would provide competition for the LLC, at least in the context of close relationships where centralized management is not desired.

The LLP movement establishes some interesting dynamics in terms of the choice of business entity. If the participants seek a UPA or RUPA structure,

181. This assumes the absence of other law precluding the use of the LLC form. *See, e.g.*, ULLCA § 112(a) ("A limited liability company may be organized . . . for any lawful purpose, subject to any specific provisions of the law of this State governing or regulating business.").

182. *See supra* notes 54-79 and accompanying text.

183. *See, e.g.*, N.Y. PARTNERSHIP LAW § 26 (b)-(f) (McKinney 1995).

184. *See, e.g.*, VA. CODE ANN. § 50-15 B, C (Michie 1994).

185. *See, e.g.*, 1994 Minn. Chapter Law 539 § 12, amending MINN. STAT. § 323.14 (1992) (LEXIS, Legis. Library, MNALS file).

186. Until a number of states adopt LLP legislation, the LLP will suffer from the LLC's initial uncertainty with respect to the recognition of the limited liability shield in interstate transactions. *See supra* note 53. As of Sept. 1, 1994, 17 states and the District of Columbia had enacted LLP legislation. In addition, three states had enacted provisions recognizing foreign LLPs imported into their jurisdictions, in the absence of a host jurisdiction LLP enabling statute. *See* Elizabeth G. Hester, *Practical Guide to Registered Limited Liability Partnerships*, in 5 STATE LIMITED LIABILITY: COMPANY & PARTNERSHIP LAWS at LLP-2 to -3 (Michael A. Bamberger & Arthur J. Jacobson eds., Supp. 3, 1994).

but with limited liability, the LLP is available and offers the benefits of a greater degree of certainty. If the nature of fiduciary duties is important to the organizers, the LLP may be subject to the existing UPA regime in a state or, ultimately, to the RUPA nonwaivable core. If either of those alternatives is objectionable, the organizers could select an LLC statute from any state, form the LLC, and register it as a foreign LLC. That course of action would open to the organizers the broad range of the LLC fiduciary duty “cafeteria” previously discussed.¹⁸⁷

B. The Limited Partnership

Barring modifications, the limited partnership as a desired form of doing business would appear to be *in extremis*, at least with respect to arrangements involving participants relatively few in number.¹⁸⁸ It is not a default entity into which one stumbles; given a choice, in the closely held context, one can better accomplish with an LLC almost everything that one could with a limited partnership. The “general partner” interests can be given limited liability under the LLC without the complications of a corporate general partner.¹⁸⁹ The otherwise passive “limited partner” interests can participate in the management of the LLC without potential liability for participating “in the control of the business.”¹⁹⁰ On the other hand, if manager governance is chosen, the

187. See *supra* part IV. RUPA specifies that the “law of the State in which a partnership has its chief executive office governs the partnership’s internal affairs.” RUPA § 106, 6 U.L.A. at 293 (Supp. 1995). The section comment states that the partners may agree to apply the law of another state, but that choice may not be respected as to nonwaivable matters (including fiduciary duties) specified under RUPA § 103(b) if the partners or partnership do not have a substantial relationship to the state chosen, or application of the law of choice would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state. The impact of the modifications set forth in the commentary has been questioned, and the overall choice of law provision has been criticized. See Alan W. Vestal, *Choice of Law and the Fiduciary Duties of Partners Under the Revised Uniform Partnership Act*, 79 IOWA L. REV 219 (1994).

188. In Colorado, for example, the increase in LLC formations is dramatic. As of January 4, 1993, there were 1,599 LLCs registered in Colorado. As of January 5, 1994, the number had increased to 4,388, a 174% increase. Registrations of for-profit corporations increased 1.8% to 159,750. However, limited partnership registrations increased 9.2% to 10,514. This might suggest that familiarity with the limited partnership is still attractive to organizers. See Tom Locke, *LLC Numbers Soar in State As Rules Eased*, 45 DENVER BUS. J., Jan. 14, 1994, § 1, at 3.

189. Those complications include the practical drawbacks of forming and maintaining both the corporate general partner and the limited partnership, together with tax classification concerns. On the other hand, those tax classification issues are well developed with respect to the limited partnership.

190. RULPA § 303(a), 6 U.L.A. 505 (Supp. 1995). This could be a drawback to the LLC in some respects inasmuch as limited partner concerns over liability for management control could often be used as a negotiating lever in limiting the voting control wielded by limited partners. On the other hand, the 1985 amendments to RULPA § 303 arguably all but eliminated this issue in adopting jurisdictions by providing an expanded number of safe harbors, including any “matters related to the business of the limited partnership not otherwise enumerated . . . which the partnership agreement states in writing may be subject to the approval or disapproval of limited partners.” RULPA § 303(b)(6)(ix), 6 U.L.A. 506 (Supp. 1995). Language was also added to RULPA § 303 (a) that provides for limited partner liability (on account of participating in control of the business) only to persons who reasonably believe, based upon the limited partner’s conduct, that the limited partner is a general partner.

traditional general partner versus limited partner management hierarchies can be achieved.

One of the few comparative advantages of the limited partnership has been its recognition by most states,¹⁹¹ but the importance of that factor has declined as the number of states adopting LLC legislation approaches fifty.¹⁹² Another advantage, familiarity with the form, will continue to decline in importance as more practitioners and business persons become better acquainted with the LLC.

Not all has been well with the LLC. The LLC has been generally less desirable as the number of members increases because of the tax sensitive requirement of potential dissolution with respect to all members. A significant advantage still enjoyed by the limited partnership is its stability. It can satisfy the tax classification continuity of life test with reference solely to the general partner interests. Dissolution is not triggered by events occurring with respect to the limited partners, an advantage if significant numbers of passive investors exist. If an event of dissolution were to occur, it can usually be dealt with at the general partner level; one need not run the gauntlet of seeking approval from the passive participants, even on a majority in interest basis, for the continuation of the enterprise.¹⁹³ Even that comparative advantage is eroding. The IRS has recently approved LLC continuity provisions tied to events occurring with respect to only member-managers, and that issue continues to evolve.¹⁹⁴ The ULLCA could nevertheless prove an unstable formula if courts broadly apply the nonwaivable power of a member to ask for dissolution in the event of claimed activities such as oppression.¹⁹⁵

The choice of entity equation could abruptly shift with changes to the limited partnership. The LLC could be undermined in comparison to both small and large limited partnerships if the LLP partner liability exculpatory provisions are extended to limited partnerships. If general partner obligations are being

191. See generally Gazur & Goff, *supra* note 1, at 427-32.

192. There currently are 47 states with LLC legislation. See *supra* notes 31-37 and accompanying text.

193. See generally Gazur & Goff, *supra* note 1, at 460-62.

194. On January 17, 1995, the IRS issued Rev. Proc. 95-10, 1995-3 I.R.B. 20, specifying the conditions under which it will consider a favorable ruling request that relates to classification of an LLC as a partnership for federal income tax purposes. 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 requires the inclusion of a broad list of 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.

195. See *supra* notes 54-62 and accompanying text. For an example of this potential under another statute, see RULPA § 802, 6 U.L.A. at 506 (Supp. 1995) (providing for limited partnership dissolution "whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement") and Mahon v. Harst, 738 P.2d 1190 (Colo. Ct. App. 1987) (applying this section to dissolve a limited partnership in connection with general partner breach of fiduciary duty). The RUPA judicial dissolution provisions would arguably not apply to a RULPA limited partnership in view of the specific treatment of this issue by RULPA § 802. See RULPA § 1105, 6 U.L.A. at 543 ("In any case not provided for in this [Act] the provisions of the Uniform Partnership Act govern.").

modified under LLP legislation, the logical next step is expanding that liability shield to all members of the limited partnership, abolishing the remnants of the limited partner control doctrine in the process. If such changes were implemented, the LLC could be displaced by the retooled limited partnership, the "limited liability limited partnership."

C. The Closely Held Corporation

The LLC is considered by some to be the entity that will make obsolete a tax-influenced subset of closely held corporations, the so-called "S corporation." The shortcomings of the S corporation from an income tax standpoint are significant and have been chronicled elsewhere.¹⁹⁶ Yet, rather than seeing the LLC as the entity that drove the S corporation to extinction, one might instead view the failings of the S corporation as the impetus for the LLC's rise. The future path of the LLC could still be altered if the perennial liberalization proposals for the S corporation were ultimately adopted.¹⁹⁷

Likewise, the LLC has enjoyed prominence because of the availability of partnership pass-through income tax treatment, avoiding the corporate income tax itself and the inversion in corporate versus individual income tax rates produced by the Tax Reform Act of 1986. However, only seven years later, the Revenue Reconciliation Act of 1993 eliminated the inversion relationship for high income individuals.¹⁹⁸ If the corporate income tax itself were eliminated or the double taxation aspects mitigated,¹⁹⁹ the attractiveness of pass-through

196. See, e.g., Gazur & Goff, *supra* note 1, at 454-57. For a recent summary of these issues, see John Yanoshak, *Rethinking the S Election*, 26 TAX ADVISER 42 (Jan. 1995). The S Corporation, however, enjoys a significant tax-related advantage over the LLC because it permits limited liability for sole proprietors and pass-through income tax treatment. The income tax status of one-member LLCs is uncertain. See *supra* note 5. Moreover, even with a two-member LLC, the potential income tax uncertainty is just one death (or other withdrawal event) removed. In that regard, § 4.01 of Rev. Proc. 95-10, 1995-3 I.R.B. 20, provides that if an LLC previously classified as a partnership subsequently has one member, the letter ruling ceases to be effective because the LLC's status as a partnership terminates.

197. So that the S corporation and partnership would truly be on an equal footing, much attention has been given to proposals for further liberalization of the S corporation taxation rules. If that were to occur, some of the tax-driven attractiveness of the LLC would be lost. See, e.g., Peter Jakubowicz, *Ways and Means Subcommittee Considers Subchapter S, Subpart F Issues*, 59 TAX NOTES 1733 (1993); Schuyler M. Moore, *Substantive Corporate Changes Included in Technical Corrections*, 70 J. TAX'N 68 (1989); James A. Woehlke, *AICPA Tax Division Works to Modernize Subchapter S*, 24 TAX ADVISER 531 (1993).

198. See generally BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 5.01[5] (6th ed. 1994) (discussing the planning implications of the Revenue Reconciliation Act of 1993); Philip R. Fink & Dean Crawford, *Should an S Corporation Election Be Terminated After the Revenue Reconciliation Act of 1993?*, 21 J. CORP. TAX'N 144 (1994).

199. There have been long-standing proposals for the integration of the corporate and individual income tax. The most recent proposals were contained in reports by the Treasury Department and the American Law Institute. The alternatives include a dividend exclusion, partnership-style conduit treatment of corporate income, a so-called "comprehensive business income tax," and an imputation credit. See, e.g., DEPARTMENT OF THE TREASURY, *INTEGRATION OF INDIVIDUAL AND CORPORATE TAX SYSTEMS—TAXING BUSINESS INCOME ONCE* (1992) (discussing as alternatives, a dividend exclusion, shareholder pass-through treatment, and comprehensive business income tax); ALVIN C. WARREN, JR., *INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES*, REPORTER'S

entities would be reduced. If the taxation influences were to shift, the LLC could wither or the comparisons shift to the state law characteristics.

Tax factors aside, the LLC provides an almost purely contractual, flexible alternative to the close corporation. A more contractual approach to the corporate form is already permitted to some degree by close corporation statutes. The Model Close Corporations Supplement, for example, permits the elimination of a board of directors and a governance structure resembling a partnership.²⁰⁰ However, such statutes are not available in all jurisdictions, and there remain vestiges of the mandatory nature of corporate law, such as an annual meeting,²⁰¹ supermajority votes with respect to reorganization and sales of assets,²⁰² and dissenters' rights.²⁰³ Some commentators have also pointed to the potentially limited scope of shareholder agreements under close corporation statutes and the potentially burdensome protections of minority shareholders.²⁰⁴

In this regard, a comparison of the LLC with the closely held corporation leads almost inevitably to two questions. First, what are the "problems" concerning closely held corporations that need to be solved? Second, how can the LLC solve them? The "problems" turn upon one's perspective. If one is an attorney trying to represent all of the parties in forming a new business enterprise, one seeks a flexible vehicle that is relatively predictable. The corporation, at this point, is advantageous in terms of experience, off-the-shelf simplicity, and predictability. If one is a minority owner, the "problem" lies in the difficult position one occupies in any enterprise governed by majority rule, coupled with the absence of a ready market for one's investment.²⁰⁵ As for a would-be controlling shareholder, the "problem" is retaining as much flexibility as possible without interference from the minority, while still attracting their capital or services.

The basic ULLCA default management rule in a member-managed LLC is per capita, with majority rule for matters in the ordinary course of business and

STUDY OF CORPORATE TAX INTEGRATION (1993) (proposing integration through a shareholder imputation credit); *Colloquium on Corporate Integration*, 47 TAX L. REV. 427 (1992). *But see* Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991) (arguing that in a corporation with dispersed ownership, the inefficiencies of the separate corporate tax may be less than usually predicted). The Revenue Reconciliation Act of 1993 created an additional incentive for investors in certain C corporations with gross assets less than \$50 million, by enacting I.R.C. § 1202 that excludes a portion of the gain recognized on sales or exchanges of the stock. Among other requirements, the corporation in question must be a C corporation.

200. *See, e.g.*, MODEL STATUTORY CLOSE CORP. SUPP. §§ 20 (shareholders' agreement), 21 (elimination of board of directors), 22 (elimination of bylaws).

201. *Id.* § 23.

202. *Id.* § 30.

203. *Id.* § 40(d).

204. *See* Keatinge et al., *supra* note 1, at 395-96.

205. Volumes have been written about the numerous ways in which a minority shareholder can be "oppressed." *See generally, e.g.*, F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS (2d ed. 1991).

unanimous consent for acts outside the ordinary course of business.²⁰⁶ If the LLC is manager-managed, matters in the ordinary course of business are decided by a majority of the managers, and acts outside the ordinary course of business may still be undertaken only with the consent of all of the members.²⁰⁷ Those rules, per capita voting and unanimous consent requirements for extraordinary acts, empower the minority, so the majority owner would bargain to change them. Distributions must be allocated among the members per capita, but distributions must be made before dissolution only to the extent or upon those events unanimously specified by the members.²⁰⁸ Those rules too can be modified by the parties, so the tensions found in the closely held corporation could be replicated in the LLC. In the uncertain environment of a new business entity, where the agreement can be highly tailored, the context can favor parties who have the resources and interest to draft a comprehensive, but perhaps subtle, operating agreement.

Another common problem of the closely held corporation is the difficulty of exit. Often there is not a ready market for one's shares, particularly for a minority stake. In the absence of agreement or of application of a close corporation statute,²⁰⁹ the death of a shareholder is generally not an occasion for dissolution or repurchase of the deceased's shares. The default rule under the ULLCA would provide for dissociation in this instance, with a repurchase of shares.²¹⁰ However, if the issue is identified by the participants, one could eliminate that result in the LLC by agreement as readily as one could create it by agreement under the corporate model. There are other events that may lead to dissolution of business entities. The Model Business Corporation Act, for example, does provide for an exit through judicial dissolution if deadlock or illegal, oppressive, fraudulent, or wasteful behavior is established.²¹¹ The Model Close Corporation Supplement also provides for assorted relief, including, in extreme cases, share purchase or dissolution.²¹² As discussed earlier,²¹³ the ULLCA provides for an oppression remedy that is even broader, a clear factor in favor of minority stakeholders.

The focus could also return to LLC fiduciary duties.²¹⁴ One might exploit differences between corporate fiduciary duties and those under the developing law of the LLC. For example, although a number of corporate statutes limit the

206. ULLCA § 404(a).

207. *Id.* § 404(b).

208. *Id.* § 406(a), (b).

209. *See, e.g.*, MODEL STATUTORY CLOSE CORP. SUPP. § 14 (providing for a compulsory purchase of shares after a shareholder's death, if provided in the articles of incorporation).

210. *See* ULLCA §§ 603 & 701.

211. *See* MODEL BUSINESS CORP. ACT § 14.30(2) (1985). *But see* Easterbrook & Fischel, *supra* note 12, at 286 ("Courts have granted involuntary dissolution sparingly. Statutes typically require either a deadlock that makes operation of the business impossible or some form of serious misconduct by those in control.").

212. *See* MODEL STATUTORY CLOSE CORP. SUPP. §§ 40, 41, 42, 43.

213. *See supra* notes 54-62.

214. *See supra* part IV.

personal liability of directors and officers, the statutes often make exceptions for particularly offensive conduct,²¹⁵ and there has been judicial resistance to contractual provisions purporting to waive corporate duties of loyalty.²¹⁶ As discussed above, the LLC statutes range from the ULLCA's core of nonwaivable fiduciary duties to the Delaware and Arkansas free contracting approach that might allow exculpation of managers and members even in cases of egregious breaches of good faith or fiduciary duty.

If one ignores the income tax aspects, are these differences enough to shift investment from closely held corporations to LLCs? With the question so framed, it is difficult to predict a result because the tax aspects have been such a dominant force.²¹⁷ If significant interstate differences arise among LLC statutes, it is equally difficult to predict whether most users will still use the local LLC statute, rather than a more flexible formula from a foreign jurisdiction. In that regard, scholarly speculation about the choice of jurisdiction for closely held corporations is mixed.²¹⁸ A potential group to whom such choices might nevertheless be important would be the prescient founders of businesses who anticipate the existence of future minority investors. Use of LLCs in this context, particularly in a manager-managed structure with somewhat passive investors, could focus part of the discussion concerning appropriate LLC fiduciary duties.

D. Publicly Traded Corporations

Most commentary discusses the LLC only in the context of closely held businesses.²¹⁹ Indeed, the title of the Arkansas limited liability company legislation, possibly one of the most flexible and exploitable statutes in the nation, addressing only small business and the pass-through tax advantages, is "The Small Business Entity Tax Pass Through Act."²²⁰ The prefatory note to the ULLCA also refers to the use of LLCs, for example, "primarily by small

215. See *supra* note 131.

216. See *supra* notes 104-10 and accompanying text.

217. Professor Mitchell has proposed that, as a clumsy patchwork affair, the law of close corporations be abolished as an entity choice. One could choose the partnership, limited partnership, or corporation. See generally Lawrence E. Mitchell, *Close Corporations Reconsidered*, 63 TULANE L. REV. 1143, 1189 (1989).

218. See, e.g., F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 2.11 (3d ed. 1987) ("Almost invariably, domestic incorporation is preferable for a close corporation, especially for a small enterprise whose operations are to be limited to one state."); Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 374 (1992) ("[T]here are significant costs and limited advantages in nondomestic incorporation"); see also Eisenberg, *supra* note 178, at 1482 ("[M]ost small publicly held corporations will be incorporated not in Delaware, but in the state in which their principal office is located, because out-of-state incorporation will normally entail somewhat higher costs than local incorporation."). But see Black, *supra* note 168, at 558 (arguing that expense of re-incorporation is modest, even for small, closely held companies).

219. E.g., Keatinge et al., *supra* note 1, at 395 ("Because LLCs restrict the transferability of ownership interests, almost all LLCs will be closely held.").

220. ARK. CODE ANN. § 4-32-101 (Michie Supp. 1993).

businesses where free transferability is not important.”²²¹ The closely held tone was initially set by the bulletproof statutes, which mandated unanimous member approvals of transfers of interests and of continuation upon an event of dissolution.²²² As a practical matter, one cannot operate a publicly traded entity in the face of such obstacles. Even with flexible statutes, the prevailing assumption is that persons would organize an LLC primarily for its partnership tax benefits, and in securing those benefits, the LLC would remain subject to restrictions on transferability and continuity of life.

During the early 1980s, the so-called “master limited partnership” was utilized as a trading vehicle.²²³ However, its tax-favored life was abruptly curtailed by enactment of the publicly traded partnership provisions of Internal Revenue Code section 7704, which, with some exceptions, prescribed corporate taxation treatment.²²⁴ A publicly traded LLC would also be subject to this provision and would be taxed like a corporation. However, apart from section 7704, the structure of such an LLC at first blush presents difficulty in passing muster as a tax partnership in the first instance. To provide free transferability and perpetual life as an investor requirement, the organizers would probably use the flexible transferability and continuity-of-life provisions of a flexible statute and provide free transferability and perpetual life.²²⁵ The Delaware LLC statute is that flexible, and Revenue Ruling 93-38²²⁶ held that such an LLC could be taxed as a corporation or as a partnership, depending upon the organizers’ selection of state law attributes. The LLC income tax classification rules, however, have been in a state of constant evolution, and the direction has been toward greater consistency with the principles applied to limited partnerships. In that regard, the IRS’s recent pronouncement, Revenue Procedure 95-10,²²⁷ suggests that if the organizer used a well-capitalized corporate manager, limited liability could be avoided, and the practical prospects for dissolution could be limited to events occurring with respect to the sole corporate manager.²²⁸ Returning full circle to a situation akin to that of

221. See ULLCA, *supra* note 6, *Prefatory Note* at 3.

222. See *supra* notes 36-40 and accompanying text.

223. See generally Program, *Publicly Traded Limited Partnership: An Emerging Financial Alternative to the Public Corporation*, 39 BUS. LAW. 709 (1984); Keith Wishon & Robert P. Roche, *Making the Switch: Corporation to Partnership*, J. ACCT., Mar. 1987, at 90.

224. See generally John W. Lee, *Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations and the Tax Legislative Process*, 8 VA. TAX REV. 57 (1988).

225. This assumes that LLC tax classification would not develop fully along limited partnership lines where “continuity of life” and “limited liability” could be evaluated with reference to only some of the members, resembling the current Treasury Regulations’ treatment of general partners. That would permit the retention of “free transferability” and “centralized management” because the other two factors could be avoided through the use of special incorporated members akin to general partners. As discussed in the text that follows, the LLC tax classification did in fact develop along limited partnership principles.

226. 1993-1 C.B. 233.

227. 1995-3 I.R.B. 20.

228. On January 17, 1995, the IRS issued Rev. Proc. 95-10, 1995-3 I.R.B. 20, specifying the conditions under which it will consider a favorable ruling request concerning classification of an LLC as a partnership for federal income tax purposes. The revenue procedure permits dissolution events relating

the master limited partnerships, the publicly traded partnership restrictions would again be the significant obstacle to overcome.²²⁹

If one concedes corporate taxation treatment of a publicly traded LLC, then from an income tax standpoint, one would be no worse off using a publicly traded LLC as a substitute for a publicly traded corporation. Therefore, publicly traded LLCs would be used for their state law characteristics, compared with corporations, not for their tax advantages.

With respect to the Delaware LLC statute specifically, until recent amendments to the statute, it could not be used as a substitute for the publicly traded corporation, but those obstacles have been removed.²³⁰ Because of its nonwaivable core of fiduciary duties and dissolution provisions for assorted misbehavior,²³¹ a statute resembling the ULLCA would not be a good choice.²³² The Arkansas statute is another potential candidate.²³³ With interstate recognition of the LLC almost assured, one state can be the national haven for publicly traded LLCs.

The greatest differences between the mandatory and contractarian views of the corporation are generally in dealing with publicly held corporations. Nevertheless, using a flexible LLC statute, one could organize a completely contractual LLC as a substitute for the corporation, eliminating whatever mandatory aspects remain.²³⁴ When *Smith v. Van Gorkom*²³⁵ was decided, its perceived stricter fiduciary rule in a takeover situation prompted the

solely to member-managers. See *supra* note 194. Although not as liberal as the dissolution provisions applicable to limited partnerships, the use of a sole corporate manager would eliminate events such as death, disability, or incompetence, and practically limit events such as bankruptcy or dissolution. With respect to limited liability, the revenue procedure permits negation of that attribute through the use of a well-capitalized (along guidelines set forth in the procedure) corporate manager. See *infra* note 280.

229. The tax definition of "public trading" is far from settled. See, e.g., Lee A. Sheppard, *What Is Public Trading?*, 67 TAX NOTES 443 (Apr. 24, 1995). The IRS recently proposed regulations which more broadly define public trading activities. See PS-13-88, 1995-21 I.R.B. 12.

230. The statute provided that once the LLC was no longer treated as a partnership for tax purposes, any member could petition for its dissolution. See DEL. CODE ANN. tit. 6, § 18-802(b) (1993). For the reasons stated earlier, as a practical matter, an LLC with freely transferable interests and continuity of life could be classified as a corporation for income tax purposes, or, failing that, could be treated as such if the section 7704 provisions apply. It is unclear whether this was an "investor expectation protection" provision, a practical limitation of the statute's application to closely held business, a protection of the Delaware franchise tax base, or some combination of those factors. It is also unclear whether the investors could exercise their contractual power by waiving this right in the articles of organization. This provision was deleted in 1995. See 70 Del. Laws c.75 § 21 (June 23, 1995).

231. See *supra* notes 57-62, 80-96 and accompanying text.

232. Some provisions of the ULLCA lend themselves to public trading of interests. For example, the names of only managers need be of public record. See ULLCA § 203(a). Certificates evidencing ownership of the LLC interests are expressly permitted. See *id.* § 501(c).

233. The Arkansas statute expressly permits the issuance of certificates of LLC interest. ARK. CODE ANN. § 4-32-704(b) (Michie Supp. 1993). The statute also limits judicial dissolution to those events available to limited partners under RULPA. *Id.* § 4-32-902. Access to LLC records is, however, subject to a looser standard than corporate law. *Id.* § 4-32-405(b) (member may inspect any LLC record "upon reasonable request").

234. Some argue that much of the mandatory structure can be avoided or does not really matter. See, e.g., Black, *supra* note 168, at 1601.

235. 488 A.2d 858 (Del. 1985).

enactment of corporate legislation that exculpated directors from personal liability for breaches of the duty of care.²³⁶ However, probably none of the legislation permits the elimination of corporate fiduciary duties of loyalty. Meanwhile, the Delaware limited partnership statute was amended to provide for contractual limitations on, and possibly elimination of, fiduciary duties, and there was some conjecture that publicly held corporations would move to the less restrictive limited partnership form.²³⁷ Apparently, there has not yet been such a movement. Perhaps it appears too bold or difficult to accomplish.²³⁸ Perhaps the duty of loyalty, as opposed to the duty of care, is efficient and “market mimicking,” so there is no pressure for change.²³⁹

Focusing on the fiduciary provisions of the ULLCA and other flexible statutes is important. However, it does not give enough significance to the other aspects of mandatory corporate law that would be rendered contractual. Except for the very limited list of provisions that cannot be varied under the ULLCA, for example, the remaining body of corporate law, boards of directors, notices, proxies, merger voting procedure, meetings, appraisal and dissenter rights, and so forth would be subject to the operating agreement.²⁴⁰ With publicly traded LLCs, there would still be the federally imposed aspects of securities laws, but otherwise the contractarians would have prevailed. In the short term, however, it could prove a Pyrrhic victory. The contractarians could initially drown in their success, in a sea of learning curve transaction costs; unlike regular corporate codes, the default provisions of the ULLCA, for example, are partnership in character and designed for more closely held enterprises. They are quite unlike any “off the rack” corporate codes now available.²⁴¹ The capital markets would need to rely on an operating-agree-

236. See generally James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988).

237. See, e.g., Larry E. Ribstein, *Unlimited Contracting in the Delaware Limited Partnership and Its Implications for Corporate Law*, 16 J. CORP. L. 299 (1991).

238. Under the ULLCA, the merger would require the usual vote of the shareholders of the merged corporation. See ULLCA § 904(c)(4). From an income tax standpoint, the publicly traded LLC should be considered a “corporation,” permitting a tax-free merger under IRC § 368(a)(1)(A) or (F).

239. See *supra* notes 166-68 and accompanying text.

240. Many commentators do not see this as a problem because they view the LLC as a closely held, partnership-like entity. See, e.g., Anderson, *supra* note 3, at 103-04:

Given the partnership nature of LLCs, however, including these detailed provisions [dissenters' rights and combinations with interested shareholders] . . . might be inappropriate. Arguably, dissenters' rights are more important in widely-held entities where individual owners are often unable to protect their interests adequately. Since LLCs, particularly member-managed LLCs, are likely to be closely held, LLC members are more apt to be capable of protecting their interests through unanimous consent requirements or the exercise of their withdrawal rights.

241. Catherine Hubbard & Lee A. Sheppard, *Guidance Forthcoming on LLC Classification, Practitioners Told*, TAX NOTES 824, 827 (1993):

Descriptions of the trouble of forming and operating an LLC left no doubt in the participants' minds that the LLC form is not useful unless the potential tax savings exceed the fees paid to corporate lawyers. . . . A corporation is easy to form and operate because residual power to manage the business resides with the management and board of directors. In an LLC, however, residual power to manage the business resides with the member

ment-by-operating-agreement examination of the intricacies of governance, publicly traded style, provided in the LLC agreement.²⁴²

By focusing on the tax aspects of LLCs and assuming that partnership income tax treatment is preferred over corporate, the drafters of flexible LLC legislation may not have appreciated the potential for bypassing the publicly held corporation as a form of doing business. That is a possibility with significant consequences beyond the scope of this paper. I believe that with the rapid, herd-like behavior of adopting states, the application of the LLC to publicly traded corporations would come as a surprise to many. Until serious consideration is given to that possibility, particularly by legislatures, I would propose that LLC legislation preclude the use of LLCs by publicly traded entities in the interim.²⁴³

VI

FORCES IN THE LLC MOVEMENT

A. Will An Interstate Race Begin?

The LLC is currently at a crossroads in its development. Already forty-seven states have adopted LLC legislation. There is no uniformity in the laws, and the drafters of the ULLCA hope that their work will be adopted to promote more uniformity and predictability. Whether there will be much incentive for uniformity, as opposed to exceptional behavior, will depend upon the nature of the forces driving the development of the LLC.

242. The master limited partnerships were influenced greatly by the requirements of "Blue Sky" state securities administrators. See Program, *supra* note 223, at 734-35. At some point, one would probably find the emergence of common features and forms, as with the bond indenture experience, but only after a learning cycle. An appraisal of the new issues raised in the implementation of publicly traded LLCs, in particular compliance with exchange listing requirements, is beyond the scope of this article.

243. This should be construed as a neutral position on the continuing paternalist/contractarian debate concerning the future of the corporation. Those who accept the contractarian model would probably view my suggestion as undesirable, as impeding healthy, headlong, unrestrained experimentation with existing corporate codes under a contractual-based LLC regime. My point is that with such a continuing disagreement among intelligent individuals (see, e.g., the commentaries listed at *supra* note 12), both sides still need to be heard *in the context of the LLC* as a potential substitute for publicly traded corporations. With the closely-held flavor of the LLC dominating discussion, I do not believe that the debate has occurred. One state, Delaware, has revisited this issue and has abandoned restrictions on public trading. See *supra* note 230 and accompanying text. The limitation could be couched in terms of number of members. The LLC has European counterparts. Some of the statutes have limitations on the number of members. The Belgian private limited company law imposed a 50-member limit for unrelated parties. See PETER MEINHARDT, *COMPANY LAW IN EUROPE* B-24(i) (3d ed. 1981). The French private limited company law also imposed a 50-member limit. *Id.* at F-24(ii). Luxembourg adopted a 40-member limit. *Id.* at L-24(ii). The model Close Corporation Supplement, in that regard, imposes a 50-shareholder limit. See MODEL STATUTORY CLOSE CORP. SUPP. § 3(b). One could also couch a limitation in terms of whether the entity is publicly traded. It is beyond the scope of this article to consider whether other standards of public trading (e.g., in a securities regulation sense) might be more appropriate.

Much has been made of the “races” in corporate law, whether to the top or the bottom, depending upon one’s perspective.²⁴⁴ For a race to develop, there must be a prize, like franchise taxes, for the competing states. In that regard, Professor Ayres has proposed that the race for closely held corporate charters is different from that for publicly held corporate charters.²⁴⁵ With respect to the closely held corporation, there is little competition because large franchise fees are not available to the state, and the closely held corporate investor tends to incorporate in the state of principal business activity, rather than utilizing “tramp” corporations.²⁴⁶ If the otherwise closely held LLC structure were adopted by publicly traded corporations, the dynamics could shift. However, as discussed below, the rush to enact LLC legislation has yet to follow a revenue driven path. Other significant forces are nevertheless at work.

B. The Constituencies

1. *State Legislatures.* Although limited liability for business investors has been under attack from some legal scholars,²⁴⁷ the rise of the LLC suggests that limitations on liability desired by certain interest groups have the support of state legislatures. The plaintiffs’ bar has opposed LLCs in some states,²⁴⁸ but the dominant trend has been toward permitting limited liability with few

244. See, e.g., William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: “Unhealthy Competition” Versus Federal Regulation*, 53 J. BUS. 259 (1980); Eisenberg, *supra* note 178; Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEG. STUD. 251 (1977).

245. See Ayres, *supra* note 218, at 374.

246. However, an official in the office of the Illinois Secretary of State has reported that in Illinois, 55% of foreign filings are from Delaware. 2 LLC REP. 94-401 (1994). That is coupled with the statistic that when no managers are listed, 95% of LLCs have five or fewer members, and in those with managers, 87% have five or fewer members. *Id.* That alone does not prove that closely held Illinois businesses are “reincorporating” in Delaware, and better information would track the principal place of business. The Delaware close corporation provisions perhaps display some lack of interest in the small corporation market. For example, the close corporation statute requires that the corporation have no more than 30 shareholders. DEL. CODE ANN. tit. 8, § 342(a)(1)(1991). This, of course, frustrates the 35-shareholder limit for S corporation status, which would presumably be of interest to many of these corporations.

247. See, e.g., Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992); Theresa A. Gabaldon, *The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders*, 45 VAND. L. REV. 1387 (1992); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1 (1994).

248. In Washington state, the plaintiffs’ bar requested amendments that would make LLC members and managers personally liable for claims tied to hazardous waste or solid waste disposal sites and that would withdraw limited liability if certain insurance coverages are not maintained. See Peter Neurath, *Bill to Create Limited Liability Companies Gets Watered Down*, PUGET SOUND BUS. J., Apr. 2, 1993, at 12. The final statute does not contain such provisions. The North Carolina Academy of Trial Lawyers attacked the North Carolina LLC legislation with respect to its elimination of joint and several malpractice liability for professionals such as accountants and physicians. See PR Newswire, *N.C. Academy of Trial Lawyers Says the Limited Liability Company Act Significantly Erodes Rights of North Carolina Citizens*, June 25, 1993, available in LEXIS, NEXIS Library, PRNEWS file.

conditions. While the LLC has other collateral aspects like the further extension of limited liability, I believe that many people still see it largely as a tax-driven entity. If only the federal fisc and perhaps the state fisc are at risk, few constituencies will counter or monitor the movement.²⁴⁹

In many states, the income tax treatment of LLCs follows the federal income tax treatment.²⁵⁰ If the LLC qualifies as a partnership for federal income tax purposes, then it also qualifies as a partnership for state purposes. Several states do impose a franchise tax or fee, or separate tax applicable to partnerships, but that still is the exceptional case.²⁵¹ If the organizers of LLCs would have otherwise formed corporations and paid a state corporate income tax, the LLC promises to be a genuine revenue loser for the states. If the LLC instead is primarily a shift from other pass-through arrangements, such as general and limited partnerships and S corporations, or even closely held C corporations,²⁵² then the revenue effects are less dramatic. The potential state tax revenue losses from LLC legislation have been raised as a concern during the legislative process, often without effect²⁵³ but sometimes with compensating actions.²⁵⁴

249. In Connecticut, for example, it was reported that “[t]he bill that would authorize the new form apparently has no opposition. Nobody testified against it at a Judiciary Committee hearing, and the committee-sponsored measure passed easily.” Thomas Scheffey, *Limited Liability, Unlimited Possibilities; Connecticut Pins Hopes for Renewed Prosperity on New Business Entity*, CONN. L. TRIBUNE, Apr. 19, 1993, at 1; see also Josephine Marcotty, *State to Allow Business Hybrid That Combines the Advantages of Corporate and Tax Worlds; New Limited Liability Companies Could Replace Partnerships*, STAR TRIBUNE, Apr. 30, 1992, at 1D (“Minnesota’s law has passed with little debate. It slid so smoothly through the House and Senate that [William Mitchell College of Law professor Carter] Bishop said one legislator described it as ‘a bipartisan love fest.’”).

250. In most states, the LLC is treated as a partnership or the state classification follows the federal classification of the LLC. See Bruce P. Ely & Allyson L. Edwards, *State Tax Treatment of Limited Liability Companies and Limited Liability Partnerships*, 66 TAX NOTES 2023 (Mar. 27, 1995). Alaska, Florida, and Pennsylvania treat LLCs as corporations. *Id.*

251. California imposes an annual minimum \$800 franchise tax and a maximum gross receipts tax of \$4,000. Delaware imposes a \$100 annual tax. The District of Columbia imposes a 10% tax on District of Columbia source income. Illinois imposes a 1.5% tax on partnerships. Kansas imposes a franchise tax on net capital accounts. Michigan and New Hampshire impose taxes on certain LLC incomes. New York imposes a \$50 per member annual fee, subject to a maximum of \$10,000. Tennessee imposes a \$50 per member annual filing fee. Texas imposes a franchise tax as a percentage of capital and earned surplus. Wisconsin imposes a temporary surcharge tax not to exceed \$9,800. *Id.*

252. Although regular “C” corporations are subject to the corporate income tax, the shareholders of closely held corporations generally engage in self-help corporate integration through the use of asset leasing from shareholders, deductible salaries and benefits, and tax favored redemptions or liquidations.

253. The New Jersey legislation, for example, was referred to the Appropriations Committee, where it was reported out favorably, and then on the same day was approved by the lower house of the legislature. See Hutcheon, *supra* note 112, at 122-23. The Oregon legislation was enacted in spite of questions raised over revenue loss. See Cameron, *supra* note 143, at 295-96 n.11. The New York LLC legislation was enacted in spite of estimates that it would “cost the state treasury between \$35 million and \$40 million a year after about five years.” Jay Gallagher, *Cuomo Signs Bill for New Kind of Small-Business Structure*, GANNETT NEWS SERVICE, Aug. 1, 1994, available in LEXIS, NEWS Library, GNS file.

254. The Tennessee annual filing fee (\$50 per member, with a \$3000 cap) was a product of the Tennessee Revenue Department’s concerns about “a possible loss of state tax revenue, fearing that entrepreneurs would chose [sic] to form LLCs instead of corporations.” H. Edward Phillips III, Note, *The Proposed Tennessee Limited Liability Company Act*, 24 MEMPHIS STATE U. L. REV. 491, 521 (1994).

2. *Business Lobbies.* So far the franchise and filing fees for LLCs have remained modest. All things considered, there does not appear to be a direct revenue incentive for states to enter the LLC charter mongering business. However, based on a number of comments from legislators and LLC supporters at the state level, many are firmly convinced the LLC is necessary to attract investment from a competitive standpoint.²⁵⁵ They view the presence of an LLC statute as attracting and retaining business in their state. Such perceptions and pro-business boosterism in the face of perceived interstate competition for small business, whether or not unfounded on the basis of entity availability, may provide a potent ingredient for a race. With the day approaching in which almost all states will have LLC legislation, the interstate comparisons will be more at the margin. An issue will be whether LLC organizers will seek to exploit the available differences, primarily in terms of flexibility, including matters of internal governance and fiduciary duty, and, if so, whether the states will further respond to that pressure.

3. *Tax and Business Lawyers.* Accounts of the development of LLC legislation on a state-by-state basis often refer to grass roots committees of the bar association, particularly tax sections.²⁵⁶ Practitioners from Colorado

255. See John M. Cunningham, *New Hampshire's New LLC: Notes of a Draftsman*, 1 LLC REP. 93-508 (1993) (quoting one of the drafters of the New Hampshire LLC statute as stating: "[w]e believed that a well-drafted LLC law would attract new capital and jobs to our state"); Blanca Mesa, *Firms Shout: "Bring Out Limited Liability Forms,"* N.J. LAW., Oct. 11, 1993, at 1 ("[One of the sponsors of the New Jersey legislation] said without LLCs New Jersey would risk losing business to neighboring states such as Delaware, which recognizes limited liability companies."); John L. Kennedy, *Is Limited Liability in Your Firm's Future?; Proposal Passes Senate Panel, Little Opposition Expected,* PA. L.J., May 31, 1993, at 6 (quoting the sponsor of proposed Pennsylvania legislation as stating: "[i]t's time for Pennsylvania to move ahead with my bill so that we can attract new companies and corporations, rather than forcing them away with our non-competitive business climate"); Kevin Sack, *New Type of Company Stirs Tax Worry in Albany,* N.Y. TIMES, June 20, 1992, § 1, at 36 ("[Lawyers and accountants] contend that many businesses might form limited liability companies in other states if New York does not authorize them soon. They cite in particular Delaware, which has long competed with New York for new business formations."). Even law review articles reflect the competitive fever. See Phillips, *supra* note 254, at 532 ("The State of Tennessee should not lag behind the current demands of the business community. For Tennessee to continue to be a desirable state in which to do business, the General Assembly should provide all possible avenues for entrepreneurs to establish the type of business entity that will best serve their needs.").

256. See Beaudrot & Houghton, *supra* note 133, at 27 ("Georgia's legislation on LLCs was conceived and drafted by a committee composed of members of the Atlanta Bar Association's Business and Finance and Tax Law Sections and the State Bar of Georgia Corporate and Banking Law Section."); Cameron, *supra* note 143, at 291 ("The original [Oregon] legislation was drafted by a task force organized by the executive committees of the Business Law and Taxation Sections of the Oregon State Bar."); Bradley J. Sklar & W. Todd Carlisle, *The Alabama Limited Liability Company Act*, 45 ALA. L. REV. 145, 183 (1993) ("The adoption of the [Alabama act] represents the culmination of several years of research and study on the part of the Alabama Law institute, in coordination with a special committee of the Tax Section of the Alabama State Bar. . . . A number of prominent attorneys from throughout the state served on this committee."); Michael Polashek, *Legislative Review, Limited Liability Company Act*, 26 ARIZ. STATE L.J. 323, 325 (1994) ("An ad hoc drafting committee of the Business Law Section of the Arizona State Bar . . . drafted Arizona's Limited Liability Company Act."); *id.* at 325 n.124 (one of the primary drafters of the Arizona act was a drafter of the ABA Prototype Act, *supra* note 120).

played an early role in promoting the second wave of LLC legislation that developed after issuance of Revenue Ruling 88-76.²⁵⁷ During 1989, this ruling reportedly "engendered tremendous enthusiasm for enacting a limited liability company statute in Colorado."²⁵⁸ Colorado enacted LLC legislation in the following year, which became effective July 1, 1990.²⁵⁹ One of the drafters of the Colorado legislation, Robert Keatinge, became a national spokesman for the LLC and participated in the drafting of the ABA Prototype Act.²⁶⁰ One much quoted account of the activities of the LLC supporters during the Spring 1992 meeting of the ABA likened the LLC to "being shown around this year's Tax Section Meeting like a new fighter plane at the Paris Air Show."²⁶¹

The enthusiasm has been infectious. Some lawyers recall the advantages of being ahead of the pack at other times. Connecticut's early adoption of RULPA helped the local legal economy, according to David Swerdloff, a Connecticut corporate lawyer: "Because we had this new, more flexible law, businesses from New York and other states came to Connecticut to get started There were more fees for the Secretary of the State and more work for Connecticut lawyers."²⁶² With the number of adopting states approaching fifty, the familiar pressures to be the most attractive LLC state of formation may mount in an effort to differentiate the offering. Since lawyers benefit from such differentiation and are also instrumental in drafting the legislation, pressures for a race could be generated by this sector.

4. *Professionals.* The accounting profession has been singled out as the force initiating drives for LLC legislation in several states.²⁶³ Already battered by professional negligence suits, accountants have been seeking relief where they can find it, such as abolishing joint and several liability among tortfeasors. Part of the relief plan includes permitting practice through entities, such as the professional corporation, registered limited liability partnership,²⁶⁴ and LLC,

257. See *supra* notes 31-37 and accompanying text.

258. Colorado Bar Ass'n, TAX'N L. SECTION NEWSLETTER (Nov. 1989).

259. COLO. REV. STAT. § 7-80-101 to -1101 (Supp. 1994).

260. See *supra* note 120.

261. Charles Davenport et. al., *ABA Tax Section Meeting: LLC Boosters Blitz Pastthrough Session*, 55 TAX NOTES 1019 (1992).

262. Scheffey, *supra* note 249.

263. The American Institute of Certified Public Accountants participated in the LLC movement by authorizing practice in any form of organization lawful in a state. AICPA CODE OF PROFESSIONAL CONDUCT RULE 505 (Am. Inst. of Certified Pub. Accountants 1992), reprinted in *Official Releases*, J. ACCT. 143 (June 1992). Accounting interests were active at the state level. See, e.g., Hutcheon, *supra* note 112, at 123 ("The New Jersey Society of Certified Public Accountants played a major role in pressing for LLC legislation. . . . The potential for using LLCs as a vehicle for limiting the liability of a member for entity obligations and the potential for interstate recognition of LLCs made this a very desirable form of organization for accountants. Hence, the New Jersey Society of Certified Public Accountants lobbied vigorously for the enactment of LLC legislation."); Matthews, *supra* note 127, at 799-800 ("The [Arkansas] bill was apparently drafted and submitted in response to the suggestion of Arkansas accountants.").

264. The form is generally a partnership in which the partners are not individually liable for one another's malpractice. See generally Martin I. Lubaroff, *Registered Limited Liability Partnerships-The*

that limit the professional's exposure to vicarious tort liability for professional malpractice by others. Although a number of states have expressly permitted the use of LLCs by accountants, others (including the ULLCA) have left that question for the regulatory bodies.²⁶⁵ Attorneys also apparently are interested in the LLC in terms of limiting their professional liability. Mr. Keatinge has recently observed that "every law firm in the country is probably looking at this in one way or another."²⁶⁶

In states where the professional corporation with limitations on vicarious liability already was available and established,²⁶⁷ the enactment of LLC legislation probably brings only marginal benefits, aside from any tax advantages.²⁶⁸ One attorney, whose firm has declined to switch from the professional corporation to an LLC form, has characterized the LLC movement as "just another fad."²⁶⁹ As discussed earlier, the LLC has a new competitor, the LLP, which also may divert interest from the LLC as a means of limiting professional liability.²⁷⁰

5. *The IRS.* Since the issuance of its pivotal 1988 revenue ruling, the IRS has been almost uncharacteristically helpful in speeding the development of the LLC. It has issued numerous favorable private letter rulings and public rulings,²⁷¹ and IRS members have actively advised practitioners and the

Next Wave, INSIGHTS, May 1994, at 23; Thom Weidlich, *Limiting Lawyers' Liability; LLPs Can Protect Assets of Innocent Partners*, NAT'L L.J., Feb. 7, 1994, at 1. Five of the largest accounting firms, Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse have reportedly reorganized as limited liability partnerships, with Arthur Andersen planning the same in a month. Bloomberg Business News, *Peat Marwick, Deloitte Reorganizing to Protect Partners*, DENV. POST, Aug. 16, 1994, at 3C.

265. See, e.g., ULLCA § 112(a) ("A limited liability company may be organized under this [Act] for any lawful purpose, subject to any specific provisions of law of this State governing or regulating business."). Reportedly, out of then 44 states permitting the formation of LLCs, only 28 permitted their use by "professional-service providers." See Richard C. Reuben, *Added Protection*, 80 ABA J. 54, 56 (1994).

266. Reuben, *supra* note 265, at 55.

267. There were some questions concerning the degree of exculpation provided in some cases by the professional corporation. See, e.g., Timothy C. Holm, *Nelson v. Patrick: More Problems for Professional Corporations*, 64 N.C. L. REV. 1216 (1986); Nora Schneider, *Incorporated Lawyers—The Veil Rises and Falls*, 55 U. CIN. L. REV. 785 (1987).

268. See, e.g., Matthews, *supra* note 127, at 848 ("It appears that any advantage the LLC may enjoy over the professional corporation must be found in some attribute other than protection from liability.").

269. Reuben, *supra* note 265, at 57.

270. See *supra* notes 183-87 and accompanying text.

271. See, e.g., Rev. Rul. 88-76 (Wyoming), 1988-2 C.B. 360; Rev. Rul. 93-5 (Virginia), 1993-1 C.B. 227; Rev. Rul. 93-6 (Colorado), 1993-1 C.B. 229; Rev. Rul. 93-30 (Nevada), 1993-1 C.B. 231; Rev. Rul. 93-38 (Delaware), 1993-1 C.B. 233; Rev. Rul. 93-49 (Illinois), 1993-2 C.B. 308; Rev. Rul. 93-50 (West Virginia), 1993-2 C.B. 310; Rev. Rul. 93-53 (Florida), 1993-2 C.B. 312; Rev. Rul. 93-81 (Rhode Island), 1993-2 C.B. 314; Rev. Rul. 93-91 (Utah), 1993-2 C.B. 316; Rev. Rul. 93-92 (Oklahoma), 1993-2 C.B. 318; Rev. Rul. 93-93 (Arizona), 1993-2 C.B. 321; Rev. Rul. 94-5 (Louisiana), 1994-2 I.R.B. 21; Rev. Rul. 94-6 (Alabama), 1994-3 I.R.B. 11; Rev. Rul. 94-30 (Kansas), 1994-19 I.R.B. 6; Rev. Rul. 94-51 (New Jersey), 1994-32 I.R.B. 11; Rev. Rul. 94-79 (Connecticut), 1994-51 I.R.B. 7; and Rev. Rul. 95-9 (South Dakota), 1995-3 I.R.B. 17. The private letter rulings are numerous.

drafters of the ULLCA on the potential income tax treatment of provisions²⁷² and have written articles addressing LLC income tax issues.²⁷³ Certainty of result feeds activity, and there are no signs that the IRS is faltering in its responsiveness to the LLC.

6. *Congress.* As noted above, the LLC may not have developed if Congress had enacted the much discussed liberalization of the S corporation rules. Elimination of the corporate income tax through corporate integration would also eliminate much of the allure of pass-through entities. However, with "revenue neutrality" as the rule for recent tax legislation,²⁷⁴ meaningful changes in these areas, most of which would be revenue losers,²⁷⁵ have not been forthcoming. Hearings to address the policy aspects of the LLC as a federal revenue drain have been proposed.²⁷⁶ In that regard, a spokesperson

272. Susan Pace Hamill, attorney-advisor with the IRS Office of Chief Counsel addressed participants at a February 1, 1993 Practising Law Institute seminar on LLCs. In that discussion it was noted that "[t]he Service is also sending representatives to drafting sessions of the National Conference of Commissioners on Uniform State Laws, which is working on a uniform LLC act and hopes to have a draft complete by the summer of 1994." Hubbard & Sheppard, *supra* note 241, at 824. Ms. Hamill was quoted as stating that "It's better to draft a statute properly and get the tax aspects correct than have to go back and amend or deal with a possible unfavorable ruling." *Id.* That quote prompted a letter of clarification from Ms. Hamill addressing other issues and the quote in particular.

The article incorrectly implies that the Internal Revenue Service is actively promoting the use of LLCs by opening up state-by-state LLC revenue ruling projects, focusing on the classification of LLCs, and sending representatives to the Uniform LLC Act drafting sessions of the National Conference of Commissioners on Uniform State Laws. Rather, these actions represent the general policy of the Service to address the needs of the public in a responsive and professional manner. The Service has taken these steps in response to requests from the American Bar Association, other organized groups, and from taxpayers in general who, since 1990, have expressed a need for guidance in this area.

Susan Pace Hamill, *Clarification of Remarks*, 58 TAX NOTES 1385 (1993). The pace continues. A revenue procedure specifically addressing the income tax classification of LLCs to be issued by the end of 1994 was promised by IRS Deputy Associate Chief Counsel Monte Jackel in a presentation at the New York State Bar Association Tax Section meeting. See Lee A. Sheppard, *LLC Revenue Procedure Coming Soon, Official Says*, 65 TAX NOTES 159 (1994). That revenue procedure was issued on January 17, 1995, as Rev. Proc. 95-10, 1995-3 I.R.B. 20.

273. Prior to accepting an assistant professor of law appointment at the University of Alabama in 1994, one of the active IRS personnel was Susan Pace Hamill, then an Attorney Adviser in the Chief Counsel's Office, Internal Revenue Service, Washington, D.C. See *supra* note 272. She has published several articles concerning the LLC. See, e.g., Hamill, *supra* note 7; Keatinge et al., *supra* note 1; Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?*, 41 FLA. L. REV. 721 (1989).

274. See generally Ronald A. Pearlman, *The Tax Legislative Process; 1972-1992*, 57 TAX NOTES 939 (1992).

275. The revenue cost of the dividend exclusion prototype when fully phased in has been estimated at \$13.1 billion per year. The more extreme comprehensive business income tax (which would eliminate the deductibility of interest by corporate taxpayers) would, however, reportedly be revenue neutral. See Department of the Treasury, *supra* note 199, at viii.

276. It was reported in early 1993 that Chairman Charles Rangel of the House Ways and Means Subcommittee on Select Revenue Measures listed LLCs as a hearings topic. See Bureau of National Affairs, Inc., *Use of Limited Liability Companies Seen Not Jeopardizing Corporate Tax Base*, 1993 BNA MANAGEMENT BRIEFING (Mar. 30, 1993). Those hearings have not been held.

for the IRS, in helpful fashion, repeated the view that, because the LLC is largely a substitute for other pass-through structures, little revenue is lost.²⁷⁷

Congress moved relatively quickly in enacting Internal Revenue Code section 7704 to stem the anticipated revenue loss from publicly traded master limited partnerships. With public trading as the mark of the villain, the target was relatively circumscribed. One could not deal effectively with the LLC without addressing S corporations and partnership classification in general, a topic for which a reappraisal is long overdue.²⁷⁸

7. *The Contractarians and Paternalists with the LLC as a Catalyst.* As a new entity altogether, it has appeared easier to bypass completely the general and limited partnership, and perhaps corporation, than to maintain a discussion concerning modifications of the existing entities, whether on terms of limited liability or fiduciary duty. Other articles in this symposium demonstrate the degree of controversy over RUPA, while the LLC has conquered the same field with little normative discussion. The LLP, first adopted by Texas, came closest

277. "What the LLC really is an alternative to business types that could already use another flow-through," agreed Susan Pace Hamill, attorney advisor, office of IRS chief counsel. "As a technical matter (the LLC) is going to displace choices where you can already use a pass-through and probably already do so," she said in a [Bureau of National Affairs] interview." *Id.*

278. Former IRS Commissioner Donald Alexander has called for amendments to improve Subchapter S and revisiting the partnership classifications rules, to move toward a facts-and-circumstances analysis, in which limited liability would play a significant factor. *Id.* Some commentators share that view. See, e.g., Fred W. Peel, *Definition of a Partnership: New Suggestions on an Old Issue*, 1979 WIS. L. REV. 989, 1015 ("The characteristic of limited liability is so significant that, if all the members of an organization have limited liability, it is suggested that the organization be classified as an association taxable as a corporation regardless of the other characteristics."). On the other hand, the American Law Institute has argued that limited liability of the participants should not bear the price tag of corporate taxation. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER K 377 (1984) ("Of what importance is it to the fisc that the participant in a business venture has limited liability or that he does not participate in management?"); *id.* at 386 ("[T]he conclusion was that the pass-through method of taxation permitted under Subchapter K is appropriate for the type of entity formed under limited-partnership statutes. It was noted that the existence of limited liability, without more, does not seem sufficient reason for imposing a corporate-tax regimen on an entity."). Another commentator has proposed that pass-through versus corporate treatment should turn on the size of the entity, and that the classification tests should be abandoned. See Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105 (1992). Professor Berger's proposal is roughly reflected in the current system due to the availability of pass-through treatment to smaller enterprises by way of the S corporation and LLC, with those benefits effectively denied to larger enterprises. "The I.R.S. has, in effect, permitted the creation of a new limited liability entity that completes the unfinished job of placing S corporations on a par with partnerships. However, this result carries the price of highly restrictive transfer and continuation provisions that may be intended, in part, to limit its utility to public tax shelter promoters or entities with many owners." Gazur & Goff, *supra* note 1, at 470; see also Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815 (1992). The IRS has acknowledged the transactions cost (and perhaps ultimate empty formalism) involved in the application of the entity classification tests by announcing a proposal for a streamlined "check-off" election for unincorporated associations. See Notice 95-14 (Apr. 3, 1995). Under the proposal, partnership classification would be the default regime for unincorporated associations (entities formed as corporations under state corporate statutes would remain such). The classification tests would be abandoned, and, so long as the entity was not publicly traded, it could qualify for partnership income tax treatment by filing the appropriate partnership tax return. See Sheryl Stratton, *IRS Proposes Check-the-Box Entity Classification Procedure*, 67 TAX NOTES 26 (Apr. 3, 1995).

to a direct approach, by limiting the vicarious liability of partners for torts, but generally retaining the partnership model in other respects. Perhaps matters could have been simplified by just revising the RULPA to absolve all members of liability, eliminating the remnants of the control doctrine, and designating the general partners as managers, but the LLC did not take that path.²⁷⁹ It is probably too late to reverse direction, although the ultimate result may be very similar.²⁸⁰

With respect to the fiduciary duties of partners, the contractarian versus mandatory provision debate has perhaps been bypassed by the LLC. In the absence of LLP amendments, the debate over RUPA and continued examination of the RULPA are both somewhat insignificant if many business arrangements will choose the LLC form. In the corporate area, too, the flexible nature of LLC legislation with respect to most structural issues could minimize any remaining mandatory aspects of corporate law as applied to closely held companies. Still, that debate may live on. The nonwaivable core fiduciary approach of the ULLCA as compared to the opt-out approach of the ABA Prototype Act suggests that the issue will be controversial as the LLC further develops.²⁸¹

With the emergence of the LLP, and its potential application to both general and limited partnerships, the nascent superiority of the LLC is already threatened.²⁸² The LLC's ultimate legacy may be its role as a catalyst, forcing changes to the partnership in terms of limiting the traditional unlimited liability of general partners. If that is so, the LLC will have been a costly, but brief experiment.

VII

CONCLUSION

The LLC has come a great distance since 1990. With perceived federal income tax advantages as the prize, the organizers of LLCs and the judicial and

279. That experiment with RULPA would have placed the income tax consequences in question during the trial-and-error period. The LLC might be seen as having served a function in pushing the IRS with respect to partnership tax classification issues. If the LLC had failed in that regard, the limited partnership and S corporation, warts and all, still will have remained as options during the development period and thereafter.

280. For income tax classification purposes, the IRS has conceded in a recent revenue procedure that continuity of life may be avoided even if events of dissolution are tied only to member-managers. See *supra* note 194. The LLC further resembles the limited partnership classification approach in that regard. Moreover, inasmuch as the ULLCA (and some state LLC statutes) permits members to agree to be liable for entity debts (*see* ULLCA § 303(c)), that may permit the LLC to avoid even the characteristic of limited liability if selected members are liable for entity debts, again an analogy to the limited partnership classification approach. The IRS has completed that analogy in Rev. Proc. 95-10, 1995-3 I.R.B. 20, § 5.04, permitting an LLC to avoid limited liability if financially responsible members assume all obligations of the LLC.

281. Professor Ribstein, a notable proponent of contractual freedom in business entity provisions, was the reporter on the ABA Prototype Act, but was not a drafter of the ULLCA.

282. See *supra* notes 183-87 and accompanying text.

regulatory system will be plunging into uncharted waters where much of the law remains to be developed. We can hope that trip will ultimately be worth the price, particularly if much discussed but always delayed structural changes are made to the federal income tax. Likewise, if general partnership and limited partnership law is modified to free partners of liability for entity obligations, much of the allure of the LLC will be lost. If either scenario proves true, the LLC will have served a purpose as a catalyst for change. By focusing on the tax aspects of the entity, attention has to some extent been diverted from the state law consequences, including the impact on existing forms of business organization. With respect to the publicly held corporation in particular, the highly flexible statutes may contain the potential for dramatic, unintended consequences of an almost entirely contractual publicly traded entity. Inasmuch as publicly traded entities are so dissimilar from the closely held businesses for which the LLC is touted, it would be desirable if a moratorium were imposed until more consideration is given this issue.

