

THE LIMITED LIABILITY COMPANY: LESSONS FOR CORPORATE LAW

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INTRODUCTION

Legal scholarship examining the recent emergence of the limited liability company has primarily focused on the legal treatment of these entities.¹ A successfully formed limited liability company is a noncorporate entity that provides its owners with protection against liability for enterprise obligations, as well as the pass-through tax treatment traditionally associated with partnerships and Subchapter S corporations. At the same time, the limited liability company form allows investors to remain actively involved in the management of the enterprise.

The purpose of this Article is different. Rather than exploring whether (or how well) the limited liability companies achieve their common intended purpose of reducing the contract, tort and tax liabilities of their investors, this Article explores the implications of the emergence of the limited liability company for our understanding of corporate law. What does the modern emergence of the limited liability company tell us about the state of American corporate law? This Article argues that the emergence of the limited liability company has much to tell us about a variety of important topics in corporate law, particularly the reasons for requiring formal incorporation, jurisdictional competition for corporate charters, the costs and benefits of limited liability, and the structural problems that may hamper sweeping reform of corporate and tort law rules affecting enterprise and investor liability.

This Article begins with a brief discussion of the limited liability company. The second part of the Article discusses the features that may

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1. See, e.g., Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW 375 (1992).

motivate state legislatures to enact statutes enabling the formation of limited liability companies. The subsequent parts of the Article discuss the lessons that the limited liability company provides. This Article argues that the emergence of the limited liability company reveals and seeks to address certain fundamental deficiencies with the structure and organization of corporate law. The final part of the Article offers some conclusions.

I. THE LIMITED LIABILITY COMPANY

Limited liability company statutes typically provide for the formation of a limited liability company by two or more persons.² As with traditional corporations, a filing with a statutorily specified department of state government must be made before the enterprise can legally exist. The precise information required in these filings differs from state to state; however, typical disclosure requirements include the name of the potential limited liability company, the period of proposed duration of the enterprise, and the resident agent for service of process.³

In general, the purpose of forming a limited liability company is to create an entity that offers investors the protections of limited liability and the flow-through tax status of partnerships. Unlike partnerships, where entity profits flow through to individual partners, corporations are treated as separate taxable entities under the Internal Revenue Code. Hence, from the investors' perspective, the income of a corporation is subject to double taxation. The double taxation results from the income earned by the corporation first being taxed to the corporation at the prevailing rates applicable to corporate earnings.⁴ If the corporation then distributes income to investors, these investors must pay taxes at whatever rate is applicable to their status.⁵ For firms that wish to distribute income in the form of dividends and that have owners in high tax brackets, it is often desirable to do business in some form that allows income to be distributed from the organizational level to the investors without being taxed at the organizational level. This, of course, is what occurs with partnerships, Subchapter

2. See, e.g., FLA. STAT. ANN. § 608.405 (West Supp. 1995) ("Two or more persons may form a limited liability company."); NEV. REV. STAT. ANN. § 86.151 (1991); UTAH CODE ANN. § 48-2b-103 (1994); WYO. STAT. § 17-15-106 (Supp. 1994).

3. See, e.g., FLA. STAT. ANN. § 608.407 (West 1993) ("Articles of Organization"); WYO. STAT. § 17-15-107 (Supp. 1994).

4. I.R.C. § 11 (1988 & Supp. V 1993).

5. *Id.* §§ 301, 316 (1988). See generally ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 295-96 (1989) (describing the problems associated with the duplicative tax treatment of corporations).

S corporations, limited partnerships, and, finally, with limited liability companies.⁶

But in order for an entity such as a limited liability company to qualify for pass-through tax treatment,⁷ and thereby avoid the double taxation of distributions, the entity must possess more "noncorporate characteristics" than "corporate characteristics."⁸ The critical issue in determining whether a limited liability company will be taxed like a corporation or a partnership is how closely it resembles a corporation. The applicable U.S. Treasury Regulations provide that a firm is a corporation rather than a partnership if it has three of the following characteristics: (1) continuity of life; (2) free transferability of interests; (3) centralization of management; and (4) limited liability.⁹ Because limited liability companies offer limited liability as a matter of course, to ensure partnership tax status, limited liability companies must lack two of the three remaining characteristics.¹⁰ Moreover, the Internal Revenue Service has clearly stated that it will grant partnership (i.e., pass-through) tax status to limited liability companies as long as they do not possess the corporate characteristics of continuity of life and free transferability of interests.¹¹

Unlike general partners in traditional general or limited partnerships, investors in limited liability companies are not liable, directly or indirectly, for any debts, obligations or liabilities of either the limited liability company or of the other investors. In this way, limited liability companies are like limited partnerships. Indeed, significant portions of most of the enabling statutes for limited liability companies were modelled on enabling legislation for limited partnerships.¹² However, unlike limited partnerships, limited liability companies have no single general partner who is exposed to unlimited personal or corporate liability.

In terms of the broad protections offered against third party liability, limited liability companies most closely resemble Subchapter S corpora-

6 See Edward J. Roche, Jr. et al., *Limited Liability Companies Offer Pass-Through Benefits Without S Corp. Restrictions*, 74 J. TAX'N 248 (1991).

7. In general, the pass-through approach taxes the members of the entity but not the entity itself. See I.R.C. §§ 701-702 (1988).

8. Treas. Reg. § 301-7701-2(a)(1) (as amended in 1993).

9. *Id.*

10. See Keatinge et al., *supra* note 1, at 424.

11. Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

12. See Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 389 (1991) (discussing the origins of the Wyoming and Florida limited liability company statutes).

tions. However, unlike S corporations, limited liability companies cannot be formed in perpetuity without losing their flow-through tax status. This limitation exists because, as noted above, the Internal Revenue Service requires that limited liability companies limit their duration in order for the lack of perpetual existence to be considered a "noncorporate characteristic."¹³ This is clearly accomplished in such states as Colorado, Virginia and Nevada, in which limited liability companies, by definition, lack continuity of life and dissolve at the expiration of a fixed period (or earlier in case of unanimous agreement of the members, or the death, retirement, resignation, bankruptcy, or expulsion of a partner) unless all of the remaining investors agree to continue the business.¹⁴

However, the disadvantage suffered by limited liability companies as a result of their finite duration is, for many firms, offset by the fact that they, unlike S corporations,¹⁵ are free from restrictions on the type and number of shareholders they may have, and on the ability of such shareholders to make allocations and deductions of income from the firm. In particular, Subchapter S limits the number of shareholders in Subchapter S corporations to thirty-five, forbids the creation of more than one class of stock, and prohibits the firm from owning a subsidiary.¹⁶ And, like other corporations, S corporations have restrictions on the amount of dividends they can pay, must maintain certain capital accounts, and must be managed by a board of directors or an equivalent body.¹⁷ None of these restrictions on organization and management are imposed on limited liability companies.

In addition to the foregoing restrictions on corporate structure, there are also tax disadvantages to Subchapter S corporations as compared with partnerships and limited liability companies.¹⁸ While partners may include their share of the partnership's debts in determining their basis for purposes of calculating the taxes to be paid on partnership distributions, shareholders in Subchapter S corporations must allocate income in direct proportion to their interests in the corporation.¹⁹

The advantages of limited liability companies over partnerships have

13. See *supra* notes 8-11 and accompanying text.

14. COLO. REV. STAT. § 7-80-801 (Supp. 1994); VA. CODE ANN. § 13.1-1046(3) (Michie 1993); NEV. REV. STAT. ANN. § 86.491 (1991).

15. I.R.C. § 1361(b)(1) (1988).

16. *Id.* § 1361(b)(1)-(2).

17. Gazur & Goff, *supra* note 12, at 445.

18. See generally *id.* at 454-57 (comparing tax ramifications of the choice between a limited liability company and an S corporation).

19. I.R.C. § 1377 (1988).

caused one commentator to argue that this new organizational form may lead to the death of partnerships, because “[m]ost firms that now organize as general partnerships probably will not continue to do so once restrictions on limited liability have been loosened through recognition of the [limited liability company form].”²⁰ If this prediction proves correct, a business environment may emerge in which all firms except sole proprietorships would enjoy the benefits of limited liability, and all firms except publicly traded corporations could enjoy the benefits of pass-through tax treatment.²¹

II. THE POLITICS OF LIMITED LIABILITY COMPANY STATUTES

As the preceding section demonstrates, the limited liability company is not difficult to understand. Such companies are privately held firms that combine the corporate-form benefits of centralized management and limited liability with the partnership-form benefits of pass-through tax treatment and organizational flexibility. It is not hard to imagine why states would want to authorize the formation of such ventures. Investors clearly will prefer limited liability to unlimited liability. Limited liability reduces exposure to loss, reduces insurance costs, and increases incentives for engaging in potentially profitable risk-taking. The only costs to investors come in the form of additional borrowing costs from creditors whose risks are increased by limited liability. But these higher borrowing costs can easily be avoided by contract if the borrower values less expensive credit higher than the benefits associated with limited liability. Participants in limited liability companies who wish to avoid additional borrowing costs

20. Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 427 (1992).

21. Publicly traded firms cannot, for structural reasons, achieve pass-through tax treatment. As noted above, because all limited liability companies have limited liability, to achieve pass-through tax treatment a firm must lack two of the following three features: central management, continuity of life, and free transferability. But, as Larry Ribstein has pointed out, because of the uncertainty surrounding these characteristics, it would be dangerous for a limited liability company to risk the disastrous consequences of being retroactively classified as a corporation for tax purposes. Larry E. Ribstein, *Form and Substance in the Definition of a Security: The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807, 821 (1994). Moreover, any firm of significant size will have centralized management. Consequently, a firm will have to lack both continuity of life and free transferability of interests in order to be assured of pass-through tax treatment. See *supra* notes 8-11 and accompanying text. Because publicly traded firms have free transferability of interests by definition, these firms will never satisfy this test. The desire to protect the tax status of limited liability companies explains why every state's enabling statute authorizing the formation of such companies restricts, without exception, the transferability of interests. See Keatinge et al., *supra* note 1, at 427-28.

simply can contract to provide further security to some or all of their creditors through personal guarantees.

Moreover, the creation of limited liability companies has provided a boon to lawyers and accountants who provide the legal and tax advice necessary to form these new entities, and has provided state governors who have clear antibusiness tax records with the opportunity to enact probusiness legislation.²² And, as Saul Levmore has pointed out, even partners that shift from a partnership form to a limited liability company form in *midstream*—that is, after they have been doing business as a partnership—could conceivably enjoy the benefits of limited liability, “even though many of these firms’ contractual creditors will be caught by surprise.”²³

Of course, any innovation produces losers as well as winners and this is true of the limited liability company as well. Creditors, particularly future tort creditors of limited liability companies, are clear losers, especially when the limited liability firms imposing the damages on tort victims would otherwise have been organized as partnerships. However, future tort victims, by definition, are unidentified and lack political force, in contrast with investors, whose identities are known and whose financial resources and political connections are prodigious. Thus, it is not surprising that the political debates surrounding the adoption of limited liability company enabling statutes have not featured much concern about the expansion of limited liability beyond previous confines.

None of the foregoing is meant to state that the costs of the limited liability company outweigh the benefits. Rather, the point is simply to emphasize that the costs and benefits issue is an empirical question, and that it is far too early in the history of these new organizational forms to make definitive conclusions about it. In particular, it is unclear how much new business activity will be generated by the opportunities presented by these entities. Moreover, as discussed in more detail below, it is questionable how courts will respond to these new organizational forms. Perhaps courts will be more willing to pierce the corporate veil if they believe that these new forms are being used to shield investors from the consequences of excessive risk-taking. And perhaps these forms will lead legislatures to see the costs as well as the benefits of jurisdictional competition for

22. Former New York Governor Mario Cuomo being the prime example. See Daily Rep. for Executives (BNA) No. 149, at H-8 (Aug. 5, 1994).

23. Saul Levmore, *Partnerships, Limited Liability Companies, and Taxes: A Comment on the Survival of Organizational Forms*, 70 WASH. U. L.Q. 489, 491 (1992).

corporate control.

The following parts of this Article explore these issues from the perspective of the general landscape of corporate law. The parts argue that the advent of the limited liability company has at least as much to teach us about U.S. law relating to business organizations as the U.S. law of business organizations has to teach us about limited liability firms.

III. REASONS FOR REQUIRING FORMAL INCORPORATION

Like traditional corporations, limited liability companies come into existence upon the filing of a document with some statutorily designated state functionary, typically the Secretary of State. Completion of these statutory formalities is a necessary precondition to achieving limited liability.²⁴ Thus, the limited liability company brings into sharp focus the fact that under U.S. law, the critical feature that distinguishes business organizations whose investors enjoy limited liability from business organizations whose investors are subject to unlimited personal liability is the necessity for a filing with a state official.

The obligation to complete a filing with a state official in order to obtain the benefits of limited liability is a strange requirement for jurisdictions to employ. There does not seem to be any relationship between a filing and the granting of limited liability. This point seems particularly true under modern state corporation statutes, which turn the formation of a corporation into a purely routine matter, far simpler even than purchasing a house or drafting a will.

The traditional reasons given for requiring a filing include: to give notice to third parties, to identify the state of incorporation, and to enable the states to collect fees. None of these reasons clearly justify the filing requirement. Plainly, the filing requirement is not necessary in order to notify third parties that the firm's investors have limited liability. Every state law governing limited liability companies requires in the firm's name the words "Limited Liability Company," "LLC" or similar language indicating that the business organization is one that offers investors limited liability.²⁵ Similar requirements exist under general corporate law.²⁶ This

24. See Keatinge et al., *supra* note 1, at 386.

25. *Id.* at 410 n.243.

26. See REVISED MODEL BUSINESS CORP. ACT § 2.01 (1984) (requiring the articles of incorporation to contain a corporate name); *id.* § 4.01(a)(1) (specifying that the corporate name must contain the word "corporation," "incorporated," "company," or "limited," the abbreviation "corp.," "inc.," "co.," or "ltd.," or words or abbreviations of like import in another language).

requirement is sufficient to provide notice to third parties. Moreover, the filing requirement serves primarily to protect the firm's investors, so from the perspective of notice to third parties, filing should be voluntary at best.

Another argument for requiring investors to complete a filing before limited liability attaches relates to statutory domicile. In the United States, firms can select their states of incorporation as they wish. And, unlike European company law, American corporate law provides that a firm's statutory domicile is unrelated to its physical location, and allows for a change of domicile with shareholder consent.²⁷ Thus, it might be argued that the formality of a filing requirement is necessary in order to be completely clear about which state's rules will apply in the absence of any such filing. But, as with the argument about limited liability, the formal filing requirement protects the investors. Consequently, there is no reason to impose sanctions on firms that do not file. Nonfiling firms simply would bear the risk that the law being applied in a particular case might not be the law they would have selected had they filed. Similarly, contracting parties, such as potential investors, who are concerned about which jurisdiction's laws will be applied in the event of litigation, can contract as to which particular jurisdiction's laws will apply in case of a dispute, or can even require that a firm file articles of incorporation in a particular jurisdiction to ensure that the laws of that jurisdiction will apply.

A more realistic concern is that a jurisdiction that did not require a formal filing might find it more difficult to collect the fees associated with the creation of a limited partnership, corporation or limited liability company. One might even argue that these franchise and chartering fees are the price that firms pay for the privilege of limited liability. Similarly, and perhaps more importantly, the filing requirement creates a need for the cadres of white collar bureaucrats necessary to process the requisite corporate forms. And, of course, the filing requirement creates artificial demand for the services of the lawyers who prepare the papers that must be filed in order for a firm to achieve limited liability status.

IV. JURISDICTIONAL COMPETITION AND LIMITED LIABILITY COMPANIES

The previous part makes clear that, as is the case with traditional corporations, limited liability companies offer states the opportunity to collect fees and to create demand for the services of influential constituencies. Thus, states have incentives to become attractive venues for the

27. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 1 (1993).

formation of limited liability companies. It seems fairly clear that a limited liability company organized in one state can do business in another state without fear of losing its limited liability. Indeed, several states expressly provide that the law of the jurisdiction in which the limited liability company is organized should be used to govern the liability of the company's investors.²⁸ With respect to the other states, as Keatinge, Ribstein, Hamill, Gravelle and Connaughton have pointed out:

[T]he choice of law rules under the Restatement [(Second) Conflict of Laws], the common law principle of comity, and the Full Faith and Credit Clause and the Interstate Commerce Clause of the U.S. Constitution all indicate that in actions against an LLC in a foreign jurisdiction, the foreign court should treat the LLC as though it were a foreign corporation and should apply the limited liability provisions of the LLC's state of organization.²⁹

The implication of this analysis is clear. As is the case with general corporate law, it seems that a limited liability company could file the requisite papers necessary to achieve limited liability status in one state, while doing most or all of its business in other states. Thus, jurisdictional competition for limited liability company charters, similar to the competition for general corporate charters that Delaware currently leads, could develop as states vie with each other for the chartering fees associated with the formation of limited liability companies.

There is much literature debating the costs and benefits of jurisdictional competition for corporate charters. The literature can be subdivided into three general analytical schools of thought: (1) the race-to-the-bottom school; (2) the corporate federalist school; and (3) the public choice school. While important modifications must be made to these theories before they can be applied in the limited liability company context, each of these theories has interesting implications for the issue of jurisdictional competition for limited liability company charters.

A. *The Race-to-the-Bottom Theory*

The phrase "race-to-the-bottom" was coined by Professor William Cary in his essay, *Federalism and Corporate Law: Reflections Upon Dela-*

28. See COLO. REV. STAT. § 7-80-901 (Supp. 1994); KAN. STAT. ANN. § 17-7636(a) (Supp. 1993); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 7.02 (West Supp. 1992); VA. CODE ANN. § 13.1-1051 (Michie 1993).

29. Keatinge et al., *supra* note 1, at 456.

ware.³⁰ Cary argued that the state of Delaware, which has long been the leading producer of corporate law in the United States, has adopted a policy of pandering to the selfish private interests of corporate management in order to cause such corporate managers to select Delaware as their preferred state of incorporation. Behind this school of thought lies both the recognition that Delaware is the leading state in the jurisdictional competition for corporate charters and the contention that "there is no public policy left in Delaware except the objective of raising revenue."³¹

The origins of the race-to-the-bottom theory can be found in *The Modern Corporation and Private Property*, the classic 1932 book by Adolph Berle and Gardiner Means, in which they observed that the separation of ownership and control was the distinguishing feature of the modern business corporation.³² The Berle-Means hypothesis stated that the highly dispersed shareholders in large, publicly held corporations would be unable to galvanize into an effective political coalition to monitor and control the incumbent management of the firms in which they had invested.³³ Consequently, management possessed the real power to control corporate affairs, and would seek to incorporate in jurisdictions with laws that were friendly to their perspective, even if hostile to the interests of shareholders.³⁴

Whatever the general problems with this analysis, and there are many,³⁵ the race-to-the-bottom theory is almost wholly inapplicable in the limited liability company context. Limited liability companies are primarily formed in order to obtain pass-through tax status. And, the combination of attributes required to obtain pass-through tax status makes it highly unlikely that a qualifying entity will have the high degree of separation of ownership and control necessary to create the organizational dynamics that concerned Berle and Means. In order to have separation of ownership and control, an organization must have centralized management and investors with no ties to management who will demand free transferability of

30. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

31. *Id.* at 684.

32. ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 4 (1932).

33. *Id.* at 4-5.

34. *Id.* at 136-38.

35. See Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORGANIZATION 225, 265-73 (1985) (arguing that shareholders benefit most from state competition).

interests. Thus, limited liability companies that are characterized by the Berle-Means separation of ownership and control simply exhibit too many of the determinative "corporate characteristics" to qualify for pass-through tax treatment under current IRS interpretations.³⁶

B. *Corporate Federalism*

The corporate federalist theory holds more promise for predicting the likely future contours of jurisdictional competition for limited liability company charters. The corporate federalists, who are generally aligned with the law and economics movement, argue that states succeed in the jurisdictional competition for corporate charters by offering a package of off-the-rack corporate law rules that enhance investor welfare. Their rationale is that competition in the product market for the goods and services produced by the firm, competition in the capital markets by firms seeking to sell debt and equity, and competition in the managerial labor market and the market for corporate control combine to limit the ability of incumbent management to engage in activities that are contrary to the best interests of a firm's shareholders.

The corporate federalists' argument has been made most forcefully by Judge Ralph Winter:

It is not in the interest of Delaware corporate management or the Delaware treasury for corporations chartered there to be at a disadvantage in raising debt or equity capital in relation to corporations chartered in other states. Management must induce investors freely to choose their firm's stock instead of, among other things, stock in companies incorporated in other states or other countries. . . .

[A] corporation's ability to compete effectively in product markets is related to its ability to raise capital, and management's tenure in office is related to the price of stock. If management is to secure initial capital and have access to capital in the future, it must attract investors away from the almost infinite variety of competing opportunities. Furthermore, to retain its position, management has a powerful incentive to keep the price of stock high enough to prevent takeovers, a result obtained by making the corporation an attractive investment.³⁷

In an important refinement and extension of the corporate federalist perspective, Professor Roberta Romano has shown that Delaware leads the

36. See *supra* notes 8-11 and accompanying text.

37. RALPH K. WINTER, *GOVERNMENT AND THE CORPORATION* 10-11 (1978).

jurisdictional competition for corporate charters because it has made a credible commitment to develop and maintain an advanced, sophisticated system of corporate law.³⁸ In particular, Delaware depends more than other states on the franchise revenues associated with the chartering business because such revenues comprise a large portion of the state's budget.³⁹ Moreover, Delaware has a number of assets that are specific to its status as the foremost purveyor of state-of-the-art corporate law. As Professor Romano noted, these assets include the state's "comprehensive body of case law, judicial expertise in corporation law, and administrative expertise in the rapid processing of corporate filings."⁴⁰

Romano's powerful analysis of the jurisdictional competition for corporate charters suggests that any state which decides to specialize in developing a sophisticated body of law relating to limited liability companies could conceivably become dominant in the provision of charters to limited liability companies in the same way that Delaware is dominant in the provision of charters to publicly held corporations.

Nonetheless, Delaware has a clear head start in this competition because the expertise developed by the Delaware judiciary in the field of corporate law is, to a large extent, directly transferable to issues that may arise regarding limited liability companies. However, many of the legal disputes that arise among participants in limited liability companies are likely to involve issues analogous to those facing small, closely held corporations, rather than issues that pertain to large, publicly held companies. And, there is some evidence that Delaware's corporate code and Delaware's rules of corporate governance are especially tailored to large, publicly held companies, rather than smaller companies with concentrated share ownership.⁴¹ If this is the case, a state other than Delaware likely will become dominant in the jurisdictional competition for the charters of limited liability companies. This proposition is likely to be true despite the fact that, in many states, limited liability companies can be organized with corporate-type centralized management⁴² rather than the more diffuse

38. ROMANO, *supra* note 27, at 39.

39. See Curtis Alva, *Delaware and the Market for Corporate Charters*, 15 DEL. J. CORP. 885, 888 n.8 (1990) (noting that 20% of Delaware general fund revenues come from franchise taxes and fees).

40. ROMANO, *supra* note 27, at 39.

41. Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 183-84 (1985) (explaining that Delaware corporate law favors those corporations with greater share dispersion).

42. COLO. REV. STAT. § 7-80-401(1) (Supp. 1994); MINN. STAT. § 322B.606 (Supp. 1995); N.D. CENT. CODE § 10-32-69 (Supp. 1993); OKLA. STAT. tit. 18, § 2013 (Supp. 1995); TEX. REV. CIV. STAT.

management structure observable in partnerships.

Delaware has never been dominant in attracting chartering business from small, closely held corporations. As Romano has observed:

[W]hen ownership of a firm is concentrated, the explicit provisions of a corporation code do not matter much, because a controlling shareholder, and hence management, can implement chosen policies without difficulty regardless of the statutory provisions (they have control of the firm). There is thus no reason [for a firm] to move [from its home state of incorporation] to incur the higher costs of a Delaware domicile until the owners anticipate undertaking new activities, or reducing control, whereupon legal rules will loom larger.⁴³

Thus, because firms have no need for the services provided by an expert judiciary, such as the one that exists in Delaware, it may be possible that no jurisdictional competition in the market for issuing limited liability company charters will emerge among states. The small degree of separation between ownership and control in most limited liability companies will allow management to obtain the flexibility afforded by Delaware corporate law without the necessity of incorporating in Delaware.

Bolstering this analysis is the empirical finding that firms that are on the verge of undergoing major, organic changes are more likely to reincorporate than other firms,⁴⁴ because of the increased probability of shareholder litigation associated with fundamental corporate changes. Put differently, as Romano has postulated, it appears likely that firms change their original state of domicile when they anticipate engaging in transactions that could be undertaken at a lower cost if the firm were chartered in another state.⁴⁵ Reduced costs arise either because the new state of domicile has a legal system that reduces the costs of entering into business, or because "the firm's new activities [are] more likely to bring it into contact with the legal system than before, that is, they [are] activities that tend to generate minority shareholder litigation. . . ."⁴⁶ Consistent with this prediction, Romano found that most reincorporations preceded or coincided with a series of distinct and identifiable transactions, such as mergers and acquisitions, the adoption of antitakeover devices, or most often, public

ANN. art. 1528n, art. 2.12 (West Supp. 1995).

43. ROMANO, *supra* note 27, at 47.

44. Romano, *supra* note 35, at 249.

45. *Id.*

46. *Id.*

offerings, particularly the first public offering by a firm.⁴⁷

Thus, according to Professor Romano's general theory about the nature of jurisdictional competition for corporate charters, it is unlikely that limited liability companies will produce vigorous competition among states for their chartering business. Limited liability companies are less likely to be sued than publicly held corporations because limited liability companies have fewer public shareholders to bring derivative-type suits. Moreover, limited liability companies do not engage in the sorts of organic corporate changes that will precipitate reincorporation under friendlier state law.

C. *Public Choice*

Of course, the very fact that forty-six states have adopted enabling legislation allowing the formation of limited liability companies is strong evidence that jurisdictional competition in fact exists. The cost to a state of offering an attractive limited liability company statute is higher than the cost to a state of offering attractive corporate law. Whenever a business forms as a limited liability company instead of as a "C" corporation, states face a possible loss of tax revenue. The C corporation's distributions to shareholders are subject to double tax liability, while the distributions by the limited liability company will be subject to pass-through tax treatment.⁴⁸ Indeed, it is these tax benefits that prompt investors to form limited liability companies in the first place. Thus, states must have determined that the losses from forgone tax revenue associated with the promulgation of these limited liability company statutes would be even greater than the losses associated with having investors form limited liability ventures in other jurisdictions.

Interestingly, states are not required to conform with the federal tax treatment of limited liability companies. Most states do not deviate from the federal provisions and allow pass-through partnership treatment of limited liability companies without any entry-level taxes or fees.⁴⁹ However, it would be possible for states to impose their own individual tax treatment on limited liability companies. For example, the New York statute provides that limited liability companies must pay an annual fee determined by multiplying the number of members of the corporation by fifty dollars.⁵⁰

47. *Id.* at 250.

48. *See supra* notes 6-7 and accompanying text.

49. *See* Brian L. Schorr & Sylvia Wong, *Limited Liability Company Law, Part Two*, N.Y. L.J., July 14, 1994, at 11 (discussing New York State tax treatment of limited liability companies).

50. *Id.*

In addition, limited liability companies in New York City must pay the four percent unincorporated business tax on net income that the city requires partnerships to pay.⁵¹ But despite that it would be possible for states to require that limited liability companies pay taxes at the same rate as corporations, most states appear to be forced by competitive pressure to conform their tax treatment of such entities to the federal practice, which permits pass-through tax treatment.

Thus, the very existence of limited liability companies supports the hypothesis that there is vigorous competition among states for chartering revenues, and that most states (not only Delaware) are responsive to competitive pressures. Moreover, it is significant that states feel this competitive pressure in the limited liability company context even though no state is likely to become as dominant in this market as Delaware has become in the competition for the charters of traditional corporations.

V. THE COSTS AND BENEFITS OF LIMITED LIABILITY

As noted above, limited liability companies afford investors and managers protection against liability for the debts and obligations of the firm. Generally, members of limited liability companies are not liable, directly or indirectly (or by way of indemnification, contribution or otherwise), for the debts, obligations or liabilities of the firm. Similarly, unlike in the partnership context, members are not liable for the tort or contractual obligations of other members of the firm, even when those obligations have been incurred in the conduct of the firm's business. The exception to this general rule is that each member of a limited liability company will be liable for the consequences of her own wrongful or negligent acts, as well as for wrongful or negligent acts of people under her direct supervision.⁵²

These liability provisions distinguish limited liability companies from general partnerships, in which all partners are generally liable for the debts of the partnership, and from limited partnerships, which have at least one general partner that is fully liable for the debts and obligations of the partnership.⁵³ In his response to Professor Ribstein's suggestion that firms should be able to choose freely among various types of organizational

51. There is minimum annual fee of \$325 per limited liability company, and a maximum annual fee of \$10,000. *Id.*

52. Keatinge et al., *supra* note 1, at 443.

53. *Id.* at 385.

forms (some with and some without limited liability),⁵⁴ Saul Levmore suggests that limited liability is appropriate only when necessary to permit the pooling of capital.⁵⁵ Thus, from Professor Levmore's perspective, in a variety of contexts in which limited liability companies have become popular, such as venture capital projects, theatrical undertakings, and real estate and oil and gas investments involving a small number of investors, limited liability may be inappropriate.

The public policy problem with limited liability is clear. If society has properly configured the legal rules affecting investors, firms and markets, then firms should only be willing to invest in projects until the marginal benefits of such projects equal the marginal costs. And, critical to this social cost-benefit analysis is the reality that some of the costs associated with a firm's investments may cause damage to third parties such as creditors and victims of torts perpetrated by the firm.

The problem with limited liability is that sometimes the costs suffered by these third parties are not internalized by the people who make (and benefit from) the decisions about what types of projects the firm should pursue. In other words, when members of a limited liability company evaluate possible investment options, they are likely only to consider those marginal costs and benefits associated with the investments that they will be required to internalize. Consequently, these members will pursue projects that are suboptimally risky from the perspective of society as a whole. Put simply, limited liability allows investors to pursue extremely risky projects and to profit from the pursuit of a "heads I win; tails you lose" strategy of project finance. The members divide the spoils of risky or dangerous projects that turn out well, while the costs associated with projects that turn out badly are largely borne by creditors and "innocent" tort victims. At an aggregate level, this imbalance results in overinvestment in hazardous industries and a concomitant underinvestment in other industries.

This proclivity to engage in excessive risk-taking, known to economists as moral hazard, exists not only in the context of the various types of business organizations (corporations, limited partnerships, limited liability companies) that offer investors limited liability, but also whenever an individual or group that causes harm lacks the resources to provide compensation to injured parties. Clearly, fixed claimants such as employees,

54. See Ribstein, *supra* note 21.

55. See Levmore, *supra* note 23, at 492.

trade creditors, lenders, and other contractual creditors are in a different position vis-à-vis the limited liability company than are tort victims. These fixed claimants will demand compensation, in the form of higher wages, higher prices or higher interest payments, for the risk that the debtor will shift its resources to increasingly risky ventures after the credit has been extended.

In addition to demanding a risk premium as compensation for limited liability, both creditors and limited liability debtors have incentives to craft credible agreements to refrain from engaging in excessive risk-taking in order to minimize wage costs, costs from suppliers and borrowing costs. The fact that firms enjoying limited liability must pay for the projected additional costs associated with such limited liability tends to align the social benefits and the social costs of their activities. For this reason, even those commentators who favor abandoning limited liability for tort creditors favor retaining limited liability for contract claimants.⁵⁶

Indisputably, the emergence of limited liability company statutes has caused some firms that would otherwise organize as partnerships to instead organize as limited liability companies. Thus, the advent of the limited liability company form has expanded the ability of investors to externalize the risks associated with their business ventures. Economic theory would therefore predict that the emergence of the limited liability company will raise the level of risk-taking beyond its previous levels. Moreover, economic theory also suggests that much of this new risk-taking will be suboptimal from a societal perspective, because the people making the decisions to pursue these risky activities are not going to bear the full costs of the damages they impose on others.

The point here is to place the expansion in perspective, rather than to assert that the extension of limited liability to members of limited liability companies is bad policy. This conclusion would be wrong for a variety of reasons, as the following sections explain. First, limited liability generates social benefits that offset the social costs described above. Second, the broad legislative grant of limited liability provided by state legislatures is tempered by common law judicial craftsmanship, particularly the judicial practice of disregarding the corporate entity under certain circumstances. Finally, once it is acknowledged that limited liability is necessary for the pooling of capital, then it is impossible to refrain from extending the

56. Henry Hansmann & Reinier Kraakman, *Toward Unlimited Liability for Corporate Torts*, 100 YALE L.J. 1879, 1881, 1919-20 (1991) (arguing that market forces compensate contractual creditors for limited recourse).

benefits of limited liability to smaller firms such as limited liability companies without creating serious economic distortions.

A. *Social Benefits from Limited Liability*

One powerful argument for limited liability is that creditors are, in some contexts, superior risk bearers to shareholders.⁵⁷ This argument seems to have particular force in the context of certain limited liability companies. Consider, for example, a limited liability company involved in theatre productions, software development, or oil and gas investments. The creditors of these ventures likely hold a diversified portfolio of loans to a variety of similarly situated concerns. Accordingly, the risks of default by one debtor are offset by the cash flows associated with the timely repayment by other debtors. By contrast, the members of these hypothetical limited liability companies likely have undiversified human capital investments in a particular limited liability company. As such, the limited liability enjoyed by limited liability companies under their respective enabling statutes may simply be a low-cost way of codifying the arrangements that such firms would reach with their creditors as a matter of contract (or by forming a partnership) in the absence of such statutes.

Even where the investors in limited liability companies are able to diversify their holdings, limited liability may be of value to them because it enables this diversification. Investors can minimize their risks by owning a diversified portfolio of assets. An investment in a limited liability company could easily be a part of an investor's diversified portfolio of investments. By holding a diversified portfolio, an investor can eliminate the firm-specific risk associated with holding individual assets. However, if the assets in the investor's portfolio do not possess the attribute of limited liability, then "[d]iversification would increase rather than reduce the risk" of investing.⁵⁸ Each investment that poses the risk of unlimited liability increases the risk that losses associated with those investments will consume the remainder of the portfolio.

Moreover, it may be efficient for limited liability companies to operate under a regime of limited liability because limited liability obviates the need for the members of such firms to monitor their fellow members.

57. This argument, first advanced by Richard Posner, see Richard Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976), has been criticized by Frank Easterbrook and Dan Fischel, see Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985).

58. Easterbrook & Fischel, *supra* note 57, at 97.

Easterbrook and Fischel's argument concerning shareholders in the context of the general corporation would seem to apply with equal force in the context of limited liability companies:

[L]imited liability reduces the costs of monitoring other shareholders. Under a rule exposing equity investors to additional liability, the greater the wealth of other shareholders, the lower the probability that any one shareholder's assets will be needed to pay a judgment. Thus existing shareholders would have incentives to engage in costly monitoring of other shareholders to ensure that they do not transfer assets to others or sell to others with less wealth. Limited liability makes the identity of other shareholders irrelevant and thus avoids these costs.⁵⁹

Of course, the costs involved in monitoring fellow shareholders or members of limited liability companies, while significant, still may be less than the costs imposed on third parties as a result of the excessive risk-taking undertaken by limited liability companies.

The point here is twofold. First, the arguments recounted above in favor of limited liability for investors in limited liability companies are valid irrespective of whether there is a public market for the investments that enjoy limited liability. Thus, contrary to Professor Levmore's suggestion that limited liability can only be justified when there is a need to pool investment dollars,⁶⁰ there are strong arguments in favor of limited liability even in ventures with only a small number of investors and no access to the public markets for capital. Indeed, the diversification arguments made here would still apply even if the limited liability company had only one investor.

The second point is slightly more subtle. There are reasonable arguments both for and against granting firms the ability to obtain limited liability against obligations to tort victims. On the one hand, granting limited liability helps firms not only to raise capital, but also to encourage investments in human and firm-specific capital. On the other hand, limiting liability may lead to excessive risk-taking because firms that enjoy limited liability do not have to internalize the full costs of their risky activities. Companies also may organize their activities into subsidiaries specifically designed to engage in risky activities in order to cabin off the rest of the firm's assets from potential tort claimants.

While the arguments in favor of limited liability are far stronger than the

59. *Id.* at 95.

60. *See* Levmore, *supra* note 23, at 492.

arguments against it, particularly in light of the negligible incidence of firms being bankrupted by tort liability,⁶¹ it is noteworthy that the public policy issues regarding the relative merits of limited liability never entered the debates about whether to permit limited liability companies. Instead, states were concerned with protecting the interests of the politically powerful businessmen and entrepreneurs who planned to take advantage of this new organizational form. The interests of potential tort victims hardly registered at all because unidentified, future tort victims are not a cognizable interest group capable of galvanizing into an effective political or lobbying coalition. In other words, regardless of the merits of this new organizational business form, the emergence of the limited liability company illustrates that the public choice, or interest group, model of the legislative process is far more robust than the public interest model.⁶²

Consistent with that perspective, legal rules reflect political influence. In the debate over limited liability companies, the groups favoring the extension of protection had such influence, and those who stand to be harmed by the extension of the range of limited liability to new organizational forms did not. The public interest in a broader sense simply was not part of the calculation.

B. Piercing the Corporate Veil

The foregoing discussion indicates that as firms that otherwise would have formed as general partnerships (or even limited partnerships with high net worth general partners) come to form limited liability companies, the chances that there will be undercompensated tort victims increases. However, this is not the end of the story. The lobbying (and fear by the states of losing tax revenues) that caused states to offer investors the option of organizing as limited liability companies is legitimate when done before

61. Hansmann & Kraakman, *supra* note 56, at 1895. The problem of huge administrative costs and attorneys' fees eroding bankrupts' estates and depriving tort victims of a fund for recovery appears far more severe than the problem of excessive risk-taking caused by limited liability.

62. The interest group theory of regulation was developed to explain the behavior of legislatures, which are seen as highly responsive to pressures from organized interest groups. The theory posits that legal rules are demanded and supplied like any other commodity. Regulation is supplied to those groups that successfully "bid" for it with compensation in the form of political support, campaign contributions, lobbying expenditures, and the like. The contours of a given law will therefore reflect a competitive equilibrium among rival interest groups affected by the law. The classic articles exploring the nature and origins of the interest group theory of regulation are George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) and Sam Peltzman, *Towards a More General Theory of Economic Regulation*, 19 J.L. & ECON. 211 (1976).

legislatures, where it is commonplace for interest groups and politicians to trade political support for legislation. But the decisional calculus is much different in the courts. Judges cannot be lobbied. Unlike legislators, who often stand to further (or further entrench) their own political careers by voting a certain way, judges are more likely to determine an issue on the merits. This unbiased perspective stems from various federal and state constitutional provisions that isolate the judiciary from political accountability.⁶³ Consequently, judges are far less responsive to interest group pressures than are legislatures.⁶⁴

And, of course, the courthouse, not the legislature, is likely to be the final stop on the road to determining the legal environment in which limited liability companies will operate. Moreover, while the potential tort victims of limited liability companies are merely an inchoate mass at the time a state legislature is deciding whether to authorize the limited liability company, in the context of a lawsuit, these tort victims—and the nature of their injury—will be clearly identifiable. For these reasons, the problems of excessive risk-taking faced by tort claimants of limited liability companies are likely to be resolved—and resolved correctly—by courts allowing such tort claimants to pierce the corporate veil. As Easterbrook and Fischel have observed, cases allowing creditors to reach the assets of shareholders “may be understood, at least roughly, as attempts to balance the benefits of limited liability against its costs.”⁶⁵

The point here is simply that since the judges deciding these cases were not among the political beneficiaries of the original interest group bargains that led to the promulgation of statutes allowing limited liability companies, these judges are in a good position to correct any imbalances and injustices caused by such firms. And, while legislators theoretically could nullify any future decisions expanding the scope of the doctrines that permit courts to pierce the veil of limited liability, the political calculus will be much different because a cognizable class of tort victims has identified itself through the filing of lawsuits. The lawyers representing these victims will be a force to be reckoned with, as will the victims and their families.

63. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 499 (1987).

64. Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 227-30 (1986).

65. Easterbrook & Fischel, *supra* note 57, at 109.

CONCLUSION

The explosive growth of limited liability companies over the past several years does not mean that such firms are desirable or efficient. Rather, the introduction of this new organizational form simply reflects that its proponents were more effective in encouraging the form than were its detractors in lobbying against it. However, this observation does not require the conclusion that such firms are undesirable and inefficient. At times, interest groups lobby for laws that are efficient from a societal perspective. These groups will do so as long as the private benefits to them of such lobbying outweigh the costs. Moreover, to the extent that lobbying produces inefficient rules relating to limited liability companies, the courts serve as an important antidote by providing an ex post balancing in which the interests of groups unrepresented in the original lobbying process are given an effective voice and a more sympathetic ear. Thus, while Saul Levmore undoubtedly is correct to describe the limited liability company as "more an unfortunate product of interest-group politics than a frontier-expanding innovation,"⁶⁶ this prescient analysis applies only to the origins of the limited liability company, not to its future development.

The limited liability company is a curious phenomenon. This Article argues that while its birth was controlled by the legislature, its future growth and development will be controlled by the courts.

66. Levmore, *supra* note 23, at 492.