

LLCS AND CORPORATIONS:
A FORK IN THE ROAD IN DELAWARE?

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The limited liability company (LLC) has evolved from a little used entity option to become the leading business entity of choice.¹ The primary impetus for this change was an Internal Revenue Service (IRS) determination in 1988 that permitted pass-through tax status for a Wyoming LLC.² Then, in 1997, the IRS passed its check-the-box regulations permitting LLCs (and other non-corporate entities) to simply opt-in to the benefits of partnership tax treatment.³ These two rulings have been viewed as having “had a profound, unprecedented, and perhaps unpredictable impact on the future development of unincorporated business organizations.”⁴ Since that time, some scholars argued that the LLC should be treated as a third, and separate, entity unto itself with its own developing body of law.⁵ Nonetheless, many courts have applied corporate law to LLCs with seemingly little appreciation of the differences between LLCs and corporations.⁶ That may be about to change.

Some legal scholars and practicing attorneys were highly skeptical of LLCs because, unlike partnerships and corporations, LLCs lacked a significant body of well-

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¹ See, e.g., LARRY E. RIBSTEIN & JEFFREY M. LIPSHAW, UNINCORPORATED BUSINESS ENTITIES (2009); Carter G. Bishop, *Through the Looking Glass: Status Liability and the Single Member and Series LLC Perspective*, 42 SUFFOLK L. REV. 459, 460 (2009) (“Until [1997], the corporation was unquestionably the dominant entity of choice for an operating business.”).

² Rev. Rul. 88-76, 1988-2 C.B. 360, obsoleted by Rev. Rul. 98-37, 1998-2 C.B. 133.

³ T.D. 8697, 1997-1 C.B. 215.

⁴ Bishop, *supra* note 1, at 460.

⁵ See, e.g., Larry E. Ribstein, *Litigating in LLCs*, 64 BUS. LAWYER 739, 741 (2009) (“[T]his Article demonstrates the dangers of failing to analyze carefully the special functions of the LLC form and forcing structures from other business associations on the LLC business entity.”).

⁶ See *id.* at 739 (“Not surprisingly, legislators and courts frequently apply rules from existing business entities. Unfortunately, they sometimes apply the wrong analogies.”).

developed, LLC-specific law.⁷ This has changed over time, and there seem to be some indications that a body of LLC law is developing.⁸ Still, LLCs are often viewed as “hybrid” entities,⁹ and as such, LLCs will be treated like a partnership in some settings and like a corporation in others.¹⁰ Of course, the other option is to treat LLCs as truly an entity unto themselves, but courts have a tendency to choose to fill in empty segments of LLC law with either partnership law or the law of corporations, rather than crafting an LLC-specific set of rules.¹¹

Among some legal scholars, one of the more controversial areas in LLC law has been courts’ treatment of plaintiffs’ requests to “pierce the veil” of LLCs.¹² Veil piercing occurs when a court disregards the veil of limited liability granted to equity holders of an entity, which is traditionally a corporation.¹³ Plaintiffs seek this option when the limited liability entity lacks resources to pay a debt, but the equity holder or holders have the resources to cover some or all of the debt.¹⁴ Thus, the plaintiff would be unable to collect on the debt because the shareholder is not liable for the debts of the corporation unless the veil is pierced.¹⁵

The veil-piercing concept has long been a part of corporate law,¹⁶ and many states

⁷ Dominick T. Gattuso, *Series LLCs*, BUS. LAW TODAY, July-Aug. 2008, at 33, 38 (“Some . . . practitioners and commentators went so far as to advise others to eschew LLCs in favor of limited liability partnerships, because limited liability partnerships had a well-developed body of law to which courts could turn.”).

⁸ Peter J. Walsh, Jr. & Dominick T. Gattuso, *Delaware LLCs: The Wave of the Future and Advising Your Clients About What to Expect*, BUS. LAW TODAY, Sept.-Oct. 2009, at 11 (stating that some recent Delaware judicial opinions “reflect a concerted effort by Delaware’s courts, legislators, and practitioners to develop a body of law for LLCs with the depth, breadth, and stability that are hallmarks of the state’s corporate law.”).

⁹ *Anderson v. Wilder*, No. E2003-00460-COA-R3-CV, 2003 WL 22768666, at *4 (Tenn. Ct. App. Nov. 21, 2003) (stating that the LLC is a “relatively new form of business entity, a hybrid” that has some of the benefits of partnerships and some of the benefits of a corporation”); Larry E. Ribstein, *Are Partners Fiduciaries*, 2005 U. ILL. L. REV. 209, 248 (2005) (citing the same).

¹⁰ See Ribstein, *supra* note 5, at 739.

¹¹ See *id.*

¹² Compare Stephen M. Bainbridge, *Abolishing LLC Veil Piercing*, 2005 U. Ill. L. Rev. 77, 77–78 (2005) with Geoffrey Christopher Rapp, *Preserving LLC Veil Piercing: A Response to Bainbridge*, 31 Iowa J. Corp. L. 1063, 1064–65 (2006). Professor Rapp explains: “Veil piercing has been one of the most hotly debated concepts in business law. Unlike many concepts in American corporate law, there are strong, even moralistic arguments on both sides of the veil piercing debate, and thus it has become a lightning rod for academic dispute.” Rapp, *supra* at 1065 (footnote omitted).

¹³ See *Walkovszky v. Carlton*, 223 N.E.2d 6, 7 (N.Y. 1966).

¹⁴ See *id.* at 9.

¹⁵ See *id.* (explaining that, nonetheless, courts cannot pierce the veil “merely because the assets of the corporation, together with the mandatory insurance coverage of the vehicle which struck the plaintiff, are insufficient to assure [the plaintiff] the recovery sought”).

¹⁶ See, e.g., I. Maurice Wormser, *Piercing the Veil of Corporate Entity*, 12 COLUM. L. REV. 496, 496

added the concept to their state's LLC law. Minnesota and North Dakota, for example, specifically incorporate the state's corporate veil piercing laws.¹⁷ Wyoming, the state that originated the LLC in the United States in 1977, did not put veil-piercing language in the original statute, but the state's court nonetheless incorporated veil-piercing principles.¹⁸

Some scholars have taken an adamant view that courts should not read the veil-piercing concept into LLC law where the underlying statute does not address the issue and have argued against including veil piercing as an option for LLCs.¹⁹ Despite this opposition, most (if not all) courts faced with the question of whether to allow piercing of an LLC veil where the statute is silent have done so.²⁰

Similarly, some courts have applied other corporate law rules to LLCs, such as granting standing for creditors of an insolvent LLC to sue the LLC derivatively, as if the LLC were a corporation.²¹ Thus, the law of LLCs seemed to be developing as a true hybrid law of partnership and corporate law, without a clearly stated rationale for how or why that should be the case.²² There is some evidence, however, that trend may be coming to an end.

The Delaware Court of Chancery in 2010 determined that, unlike similarly situated creditors of Delaware corporations, LLC creditors of an insolvent LLC do not have standing to pursue a derivative claim against the LLC under Section 18-1002 of the Delaware Limited Liability Company Act.²³ The plaintiff in that case, CML V, loaned money to JetDirect Aviation Holdings, LLC, and JetDirect's operating companies went into bankruptcy.²⁴ In an effort to recover the loan, CML V instituted three derivative claims alleging bad faith and breaches of fiduciary duties against the board and senior

(1912) (discussing the difficulty of knowing “when to apply fearlessly the theory of the existence of a corporation as entity distinct and separate from its shareholders and when, on the other hand, to just as fearlessly disregard it”).

¹⁷ MINN. STAT. § 322B.303(2) (2003) (“The case law that states the conditions and circumstances under which the corporate veil of a corporation may be pierced under Minnesota law also applies to limited liability companies.”); N.D. CENT. CODE § 10-32-29(3) (“The case law that states the conditions and circumstances under which the corporate veil of a corporation may be pierced under North Dakota law also applies to limited liability companies.”).

¹⁸ See *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323, 326–27 (Wyo. 2002).

¹⁹ See, e.g., Bainbridge, *supra* note 12, at 79 (“[O]ther than in those jurisdictions whose statute commands courts to do so, courts have erred by importing the corporate veil piercing doctrine into LLC law.”).

²⁰ See Rapp, *supra* note 12, at 1065.

²¹ See Ribstein, *supra* note 5, at 739.

²² Cf. *id.* at 755 (“A generation after the LLC’s birth, it is time to start analyzing the LLC as a distinct business entity and to stop dressing it in hand-me-down clothes.”).

²³ CML V, LLC v. Bax, 6 A.3d 238 (Del. Ch. Nov. 3, 2010).

²⁴ *Id.*

management.²⁵ If those claims were successful, the liable individuals would pay JetDirect directly.²⁶ CML V would then be able to recover the funds through a direct claim alleging that JetDirect breached the loan agreement with CML V.²⁷

In the opinion, Vice Chancellor Laster noted that “[d]espite the ostensibly obvious implications of the statute, virtually no one has construed the derivative standing provisions as barring creditors of an insolvent LLC from filing suit.”²⁸ In fact, the opinion notes, there was significant commentary assuming that creditors could sue an insolvent LLC derivatively.²⁹ In contrast, there was almost nothing to indicate that plaintiffs, practicing attorneys, or other commentators thought a derivative suit was excluded by Section 18-1002.³⁰

Nonetheless, after careful analysis, Vice Chancellor Laster determined that it did “not create an absurd or unreasonable result to deny derivative standing to creditors of an insolvent LLC.”³¹ Instead, he noted that the Delaware LLC Act, unlike the comparable provision in the Delaware General Corporation Law, created a derivative claim exclusively for “a member or an assignee.”³² As such, the plain language of the LLC Act meant that creditors lacked standing to pursue a derivative claim.³³ Furthermore, this “outcome does not frustrate any legislative purpose of the LLC Act; it rather fulfills the statute’s contractarian spirit.”³⁴

The *CML V* decision portrays a heightened appreciation for the distinct nature of LLCs not often found in reviewing courts’ decisions.³⁵ For his part, Vice Chancellor Laster explains, “As a threshold matter, there is nothing absurd about different legal principles applying to corporations and LLCs.”³⁶ This view of LLCs is hardly the default.

More typically, courts provide LLC claimants the same rights in LLC cases that would be available in corporate cases. For example, the New York courts determined that LLC derivative suits were available under New York law, even though the statute

²⁵ *Id.*

²⁶ *Id.* at 240.

²⁷ *Id.*

²⁸ *Id.* at 242.

²⁹ *See id.*

³⁰ *Id.* at 242–43.

³¹ *Id.* at 254.

³² *Id.* at 241.

³³ *Id.* at 241–42.

³⁴ *Id.* at 254.

³⁵ *See id.* at 238.

³⁶ *Id.* at 249. “Because the conceptual underpinnings of the corporation law and Delaware’s [alternative entity] law are different, courts should be wary of uncritically importing requirements from the DGCL into the [alternative entity] context.” *Id.* at 250 (alterations in original) (quoting *Twin Bridges Ltd. P’ship v. Draper*, 2007 WL 2744609, at *19 (Del. Ch. Sept. 14, 2007)).

“omit[ted] all reference to such suits.”³⁷ The court based its decision in significant part “on the long-recognized importance of the derivative suit in corporate law.”³⁸ Similarly, in another key LLC case, the Wyoming Supreme Court stated that, to decide if piercing the LLC veil was permissible, “we must first examine the development of the doctrine within Wyoming’s corporate context.”³⁹ In the view of these courts, the state corporations laws provide the context in which the LLC laws operate.

Many courts thus seem to view LLCs as close cousins to corporations, and many even appear to view LLCs as subset or specialized types of corporations.⁴⁰ A May 2011 search of Westlaw’s “ALLCASES” database provides 2,773 documents with the phrase “limited liability corporation,” yet most (if not all) such cases were actually referring to LLCs—limited liability *companies*.⁴¹ As such, it is not surprising that courts have often failed to treat LLCs as alternative entities unto themselves. It may be that some courts didn’t even appreciate that fact.

The point here is that not that LLCs must have different rules than corporations, although is the likely preference of some commentators.⁴² Vice Chancellor Laster’s decision in *CML V* was not the only proper or conceivable outcome where the autonomy of the LLC as an entity would be respected. However, the “threshold matter” from *CML V* should be the default rule in analyzing all LLC questions: “[T]here is nothing absurd about different legal principles applying to corporations and LLCs.”⁴³

Where legislatures have decided that distinctly corporate concepts should apply to LLCs—such as allowing piercing the veil or derivative lawsuits—those wishes (obviously) should be honored by the courts.⁴⁴ And where state LLC laws are silent, the court should carefully consider the legislative context and history, as well as the policy implications of the possible answers to the questions presented. Courts should put forth cogent reasons for their decisions, rather than blindly applying corporate law principles in

³⁷ *Tzolis v. Wolff*, 884 N.E.2d 1005, 1006 (N.Y. 2008).

³⁸ *Id.*

³⁹ *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323, 325 (Wyo. 2002).

⁴⁰ Ribstein, *supra* note 5, at 755 (stating that “a basic problem with LLC jurisprudence [is that LLCs have] been viewed as a hybrid of older types of business associations”).

⁴¹ See, e.g., *Deuley v. DynCorp Intern., Inc.*, 8 A.3d 1156, 1156, 1158 (Del. Supr. 2010) (listing DynCorp International LLC “as a Delaware Limited Liability Corporation” in the caption, but stating that the entity “is a limited liability Delaware company” in the text of the case).

⁴² See, e.g., Ribstein, *supra* note 5, at 755 (“[T]he derivative remedy is inappropriate in the sort of closely held firms for which LLC statutes are designed.”).

⁴³ *CML V, LLC v. Bax*, 6 A.3d 238, 249 (Del. Ch. Nov. 3, 2010).

⁴⁴ Bainbridge, *supra* note 12, at 79 (stating that unless a state LLC statute “commands” applying the veil piercing concept to LLCs, the concept should not apply).

what are seemingly analogous situations between LLCs and corporations.⁴⁵

The members of an LLC chose the LLC as their entity, and they should enjoy both the benefits and burdens of that choice.⁴⁶ Where courts refuse to acknowledge the distinct nature of LLCs, the promoters' choice of entity is, at least in part, ignored. In *CML V*, Vice Chancellor Laster respected the LLC as a form, as well as the legislature's choice of language in the Delaware LLC Act. Hopefully future courts, and thus the law of LLCs, will follow suit.

⁴⁵ *See id.* (stating that courts are often applying the veil piercing doctrine to LLCs “in a way that can only be described as unthinking”); Ribstein, *supra* note 5, at 747–55 (explaining that courts are often wrong to assume that corporate law remedies are often not the best or appropriate alternative for LLCs).

⁴⁶ *Cf.* *eBay Domestic Holdings, Inc. v. Newmark*, No. 3705, 2010 WL 3516473, at *23 (Del. Ch. Sept. 9, 2010) (“Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form.”).