



January 1999

Check-the-Box: An Opportunity for States to Take Another Look at Business Formation

David M. Deaton

Recommended Citation

David M. Deaton, Comment, *Check-the-Box: An Opportunity for States to Take Another Look at Business Formation*, 52 SMU L. REV. 1741 (1999)

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CHECK-THE-BOX: AN OPPORTUNITY FOR STATES TO TAKE ANOTHER LOOK AT BUSINESS FORMATION

David M. Deaton*, **

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* B.A., University of California at Irvine, 1992; J.D., Southern Methodist University School of Law, *magna cum laude*, 1999. David Deaton is a member of the Order of the Coif and is currently an Associate at O’Melveny & Myers, LLP in Los Angeles, California.

** I would like to thank Professors Alan R. Bromberg, Christopher H. Hanna, and Marc I. Steinberg, who offered invaluable guidance and perspective as I wrote this Comment. Also, I am grateful for the thoughtful editorial remarks made by Daniel Deaton, Dena DeNooyer, Joann Pigeon, and Anne Trinklein—each of whom reviewed a prior draft. Any errors, omissions, or oversights are my own.

This Comment is dedicated to my three daughters—Lydia Anne, Hannah Elizabeth, and Mary Jean—and most of all to my wife, Shelly, who is my partner and inspiration.

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I. INTRODUCTION

FIFTY years ago, a businessperson had essentially four options in forming a business: sole-proprietorship, corporation, limited partnership, or general partnership.¹ Since then, laws with diverse possibilities have exploded in every state. Apart from the traditional business forms, parties to a business can now choose from a limited liability partnership (LLP),² limited liability company (LLC),³ statutory close corporation,⁴ or a limited liability limited partnership (LLLP).⁵

This expansion is mostly attributable to state legislatures trying to keep pace with changing federal tax law.⁶ State lawmakers manipulated statutes to offer business forms that combined limited liability and favorable (i.e., pass-through)⁷ federal income taxation.⁸ Indeed, the statutes gov-

1. See generally ROBERT W. HAMILTON, BUSINESS ORGANIZATIONS: UNINCORPORATED BUSINESSES AND CLOSELY HELD CORPORATIONS: ESSENTIAL TERMS AND CONCEPTS § 1.1 (1996) (outlining "major changes" in closely held businesses since the 1950s).

2. See, e.g., CAL. CORP. CODE §§ 16951-16962 (West 1991 & Supp. 1999); N.Y. PARTNERSHIP LAW §§ 121-1500 to -1506 (McKinney 1998 & Supp. 1999); TEX. REV. CIV. STAT. ANN. art. 6132b (West 1970 & Supp. 1999).

3. See, e.g., CAL. CORP. CODE §§ 17000-17705 (West 1991 & Supp. 1999); N.Y. LTD. LIAB. CO. LAW §§ 101 to 1403 (McKinney 1998 & Supp. 1999); TEX. REV. CIV. STAT. ANN. art. 1528n (West 1997 & Supp. 1999).

4. See, e.g., GA. CODE ANN. §§ 22-901 to -950 (Harrison 1990 & Supp. 1996); 805 ILL. COMP. STAT. §§ 5/2A.05-2A.60 (West 1993 & Supp. 1999); 15 PA. CONS. STAT. ANN. §§ 2301-2337 (West 1995).

5. See, e.g., COLO. REV. STAT. ANN. §§ 7-64-1001 to 7-64-1010 (West 1999); DEL. CODE ANN. tit. 6, § 17-214 (1974 & Supp. 1996). TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 2.14 (West Supp. 1999).

6. See Symposium, *Check-the-Box and Beyond: The Future of Limited Liability Entities*, 52 BUS. LAW. 605, 608-10 (1997) [hereinafter *Check-the-Box and Beyond*]; Dale A. Oesterle & Wayne M. Gazur, *What's in a Name?: An Argument for a Small Business "Limited Liability Entity" Statute (With Three Subsets of Default Rules)*, 32 WAKE FOREST L. REV. 101, 102-03 (1997) [hereinafter Oesterle & Gazur] ("Drafters of the new small business forms aimed to decouple limited liability from a corporate level tax.").

7. See *infra* text accompanying notes 31-36.

8. The development of the LLC is a classic example of federal taxation's role in the formation of business statutes. In the sixteen months following Revenue Ruling 88-76, which classified the LLC as a partnership for federal taxation purposes, LLC filings in Wyoming increased seventy-three percent (totaling thirty-two new filings). See Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 440-41 (1996) [hereinafter Hamill, *The Limited Liability Company*]. Within four years of the Service's ruling, 8,500 new LLCs were created. See *id.* In 1993, the thirty-two states that had adopted LLC statutes had a total of 23,000 filings for

erning business organizations today would probably have been structured much differently had past tax pressures been less intrusive.⁹ The morass that developed, whatever the reason,¹⁰ is complicated,¹¹ irrational,¹² and inconsistent.¹³

Now these tax pressures have, in large part,¹⁴ been relieved.¹⁵ In May 1996, the Department of Treasury (the "Treasury") implemented new regulations, known as the "check-the-box" regulations,¹⁶ which relieve the federal tax pressure on state legislatures.¹⁷ The check-the-box regulations present a unique opportunity for states to examine why statutes have developed as they have and to consider re-working the entire statutory scheme.¹⁸

the year. *See id.* at 442. For more information on the development of the LLC, see *infra* text accompanying notes 187-219.

9. *See generally* Oesterle & Gazur, *supra* note 6, at 104 (suggesting that states must "start from scratch . . . [to] construct a business organization statute that is internally coherent, flexible, understandable, and consistent with organizers' intuitive sense of how the structure should work.>").

10. One commentator argues that other reasons statutes may have developed the way they did is because of over reliance on "imperfect legislator incentives" or interest group pressures. *See* Larry E. Ribstein, *Limited Liability Companies: Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L. Q. 369, 402-03 (1995) [hereinafter Ribstein, *Theories and Evidence from LLCs*].

11. *See* Oesterle & Gazur, *supra* note 6, at 104 (explaining that "[some] find the still-developing maze of alternate forms of business organization difficult to navigate and unduly costly").

12. One commentator has cited three reasons why the "maze" of business organization is irrational: (1) many statutes contain obsolete provisions that were based on Treasury Regulations; (2) the various titles of the different forms create havoc with regulatory statutes; and (3) as states amend the statutes they are "driving all forms toward each other." *Id.*

13. *See generally* Robert R. Keatinge et al., *Limited Liability Partnerships: The Next Step in the Evolution of the Unincorporated Business Organization*, 51 BUS. LAW. 147, 207 (1995) [hereinafter Keatinge et al., *Limited Liability Partnerships*] (emphasizing that "[o]ne unavoidable consequence of this evolution is the laws develop inconsistently, with differing procedural and substantive provisions. It seems certain this trend will continue.>").

14. There remains one "nagging" federal tax issue. Chapter 14 of the Internal Revenue Code may limit the ability of estate planners to use the LLC as a wealth transfer device. *See* KATHRYN G. HENKEL, *ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS* §§ 15-16 (Supp. 1998); Oesterle & Gazur, *supra* note 6, at 132-41.

15. *See* Laurel Wheeling Farrar & Susan Pace Hamill, *Dissociation from Alabama Limited Liability Companies in the Post Check-the-Box Era*, 49 Ala. L. Rev. 909, 934-35 (1998) [hereinafter Farrar & Hamill] (commenting on the irony that valuation rules under section 2204 of the Internal Revenue Code keep some taxation issues in the forefront).

16. *See* Treas. Reg. §§ 301.7701-1 (1996), 301.7701-2 (1996), 301.7701-3 (1998).

17. *See generally* Oesterle & Gazur, *supra* note 6, at 114; *Check-the-Box and Beyond*, *supra* note 6, at 608-10 (claiming the new regulations "mark the toppling of the old, formalistic regime").

18. Check-the-box may prompt several changes, including:

- [1] business association statutes such as those for LLCs and limited partnerships, which have included partnership features for tax purposes, including multiple owner requirements, restrictions on transferability and continuity, and decentralized management, will now be amended to eliminate these features;
- [2] the C corporation no longer will be used by closely held firms; and
- [3] differences among business associations will become less important as statutes are no longer used for tax-classification purposes.

This Comment proposes that states maximize this opportunity by simplifying business entity statutes into a three-statute model—the general partnership, the LLC, and the corporation. This model first contemplates the general partnership, which would serve as a catch-all entity for parties that have chosen not to file with the state. Second, the LLC must be highly flexible to accommodate the limited partnership, close corporation, LLP, and other business entities. In order to do this, the LLC should entail a comprehensive set of default rules, yet should remain flexible by remaining largely contractarian in nature.¹⁹ Third, the corporation should have a series of traditional, mandatory rules to serve large, publicly held corporations and their shareholders. States should focus their attention and resources on these three business forms and should allow the limited partnership, LLP, close corporation, and other miscellaneous business forms to fall by the wayside.

There is considerable support among commentators for some form of simplification of business organization statutes.²⁰ But other commentators have argued against simplification. For example, Professor Larry E. Ribstein suggests that “separate statutes suit the needs of different types of firms. Partly for regulation (and past tax) reasons, different statutes have attracted their own ‘clienteles’ of firms.”²¹ Surely “different statutes have attracted different clienteles of firms,” but that has largely been because of tax reasons that, as Professor Ribstein indicates, are now in the past.²²

Because these tax reasons no longer exist, if states can simplify their statutes, they should. Simplification helps the business organizer who may lack the acumen necessary to recognize that choice of entity could have severe repercussions in tax, securities, or other areas. The general public also benefits from a simplified statutory scheme by being able to more quickly recognize an entity and by knowing what type of liability protection accompanies that particular entity. Additionally, it is more likely that investors know their rights, thereby giving them the ability to

Check-the-Box and Beyond, *supra* note 6, at 610; Oesterle & Gazur, *supra* note 6, at 104.

19. See *infra* text accompanying notes 242-334.

20. Professors Larry E. Ribstein and Mark A. Sargent edited an on-line discussion between lawyers and law professors regarding the impact of the check-the-box regulations' on unincorporated business entities. Several participants argued for simplification of business statutes. See *Check-the-Box and Beyond*, *supra* note 6, at 612-15, 617-18; see also Mark J. Loewenstein, *A New Direction for State Corporate Codes*, 68 U. COLO. L. REV. 453, 470-73 (1997) [hereinafter Loewenstein] (“In light of the check-the-box regulations . . . state legislatures should reexamine the statutes authorizing the formation of the noncorporate entities with a view to consolidating these statutes.”); Oesterle & Gazur, *supra* note 6, at 141-48 (proposing the “limited liability entity,” which would contain a set of core provisions along with three alternative default rules: one where all investors are active in firm management, one that has unsophisticated passive investors, and one that has sophisticated passive investors).

21. *Check-the-Box and Beyond*, *supra* note 6, at 612.

22. *Id.*

make more informed business decisions.²³ For example, an investor in a corporation will be able to quickly determine that corporate stock is transferable. But the same investor in an LLC will know to look to the LLC agreement to determine whether LLC interests are transferable.

In short, our existing system benefits practitioners and academics who thrive on sorting out the choice of entity issue. Given the past tax pressures that shaped the business forms we know today, it is understandable that confusion exists. But to continue as though this is what states would have wanted all along is disingenuous. Check-the-box has come, the tax pressures are off, and it is time to simplify.

II. BACKGROUND

A. TAXATION BACKGROUND

Much of the choice-of-entity decision is based on how the entity will be taxed. Hence, before an effective analysis of business forms can begin, the influence of federal taxation must be discussed.

1. Corporation vs. Partnership

The primary distinction between corporate and partnership taxation is whether the entity will be double taxed. Corporations are subject to the "double tax regime" of subchapter C of the Internal Revenue Code (the "Code").²⁴ Double taxation occurs when a C corporation realizes taxable income or gain²⁵ and then distributes cash or property to its shareholders. Income or gain at the shareholder level must be recognized in distributions,²⁶ redemption,²⁷ and liquidation.²⁸ Thus, if a C corporation realizes a \$100 gain on the sale of property and subsequently pays out \$100 in dividends, \$50 to each of its two shareholders, then the corporation will be taxed on the \$100 gain,²⁹ and each shareholder must include his \$50

23. See Loewenstein, *supra* note 20, at 473 ("[With a simplified approach,] the choice of entity would be more clear to the client, who could then make a more informed decision than is likely under current law.")

24. See I.R.C. §§ 301-85 (1999).

25. See I.R.C. §§ 11, 311, 336 (1998).

26. Dividends, which are distributions of the corporation's earnings and profits, are always included in gross income. See I.R.C. §§ 61(a)(7), 301(c)(1), 316 (1998). Distributions in excess of the corporation's earnings and profits are applied against the shareholder's stock basis. See I.R.C. § 301(c)(2) (1998). Amounts that exceed the shareholder's stock basis must be recognized as capital gain. See I.R.C. § 301(c)(3) (1998).

27. A stock redemption is treated as an exchange if the conditions in subsections (1), (2), (3), or (4) of section 302(b) are met. See I.R.C. § 302(b) (1998). Otherwise, redemptions are treated as distributions. See I.R.C. § 301(c) (1998).

28. "Amounts received by a shareholder in a distribution in complete liquidation . . . [are] treated as . . . full payment in exchange for the stock." See I.R.C. § 331(a) (1998). If gain or loss is recognized, shareholder basis is fair market value at the time of distribution. See I.R.C. § 334(a) (1998). For a discussion on Subchapter C's double tax regime, see 1 EDWIN T. HOOD & JOHN J. MYLAN, FEDERAL TAXATION OF CLOSE CORPORATIONS § 1.01 (1998); see also 1 ZOLMAN CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 2.04(1) (1999) (describing double taxation as the "weightiest criticism of the corporate form").

29. See I.R.C. §§ 311, 336 (1998).

dividend in gross income.³⁰

Partnerships, by contrast, are taxed under subchapter K of the Code, which does not double tax.³¹ Partnerships are taxed using pass-through taxation.³² Accordingly, a partnership pays no federal income tax; it must only file an informational return that reports the partnership's income, gain, loss, and deduction.³³ These items are passed through to the individual partners,³⁴ and each partner is then taxed on the partnership's gain or loss based on his interest in the partnership.³⁵ Thus, in the preceding example, if a partnership realizes a \$100 gain and allocates \$50 to each partner, then \$100 flows through the partnership and each partner must include \$50 in gross income.³⁶

Aside from a single level of taxation, subchapter K has other advantages over subchapter C. First, partnerships have enormous flexibility in allocating profits and losses. As long as an allocation reflects the true financial reality between the partners (i.e., substantial economic effect), partners can structure their financial agreement however they wish.³⁷ For example, an equal partnership can allocate ninety percent of partnership income to one partner and ten percent of partnership income to the other. Similarly, the same partnership can allocate all foreign income to one partner and all domestic income to the other. Both of these allocation schemes are valid if they have substantial economic effect.³⁸

Second, partnership liabilities increase a partners' basis in their partnership interest.³⁹ This is valuable because an increased basis decreases the amount of gain partners must recognize from partnership distribu-

30. See I.R.C. § 61(a)(7) (1998).

31. See I.R.C. §§ 701-61 (1999). See generally 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS §§ 9.01-9.06 (2d ed. 1990).

32. Also called conduit or flow-through taxation.

33. See I.R.C. § 6031 (1998).

34. See I.R.C. § 702 (1998).

35. See I.R.C. §§ 61(a)(13), 701-02 (1999). The tax consequences to each partner are determined by the partnership agreement. See I.R.C. § 704(a) (1999) ("A partner's distributive share of income, gain, loss, deduction, or credit shall . . . be determined by the partnership agreement.").

36. See I.R.C. §§ 61(a)(13), 702, 704(a) (1999).

37. To ensure that the partnership's allocations truly reflect the financial relationship between the partners, the Treasury Regulations require that two tests be met for each allocation: the economic effect test and the substantiality test. An allocation has economic effect if (1) the partnership properly maintains capital accounts, (2) the partnership liquidates in accordance with positive capital accounts, and (3) each partner is unconditionally obligated to restore any deficit in his capital account. See Treas. Reg. § 1.704-1(b)(2)(ii)(a), (b) (1997). The economic effect test verifies that the allocation is consistent with the partners' underlying economic arrangement.

The substantiality test is met "if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership . . ." Treas. Reg. § 1.704-1(b)(2)(iii)(a) (1997). In other words, if the partnership agreement allocates all foreign income to partner A and all domestic income to partner B, then there must be a reasonable possibility that either domestic or foreign income could change such that one partner could be worse off and the other better off.

38. See Treas. Reg. § 1.704-1(b)(2) (1997).

39. See I.R.C. § 752(a) (1998); Treas. Reg. §§ 1.752-1, -2, -3 (1991); see also I.R.C. §§ 752(b), 722, 733(1), 705(a)(2) (1998).

tions.⁴⁰ Also, partners may recognize partnership losses to the extent of their basis in the partnership.⁴¹

There is one other form of corporate taxation. Corporations that qualify as a "small business corporation" can escape the double tax by electing to be a subchapter S corporation.⁴² Subchapter S of the Code allows an incorporated organization to receive pass-through taxation, but there are several undesirable qualities about subchapter S.⁴³ First, in order to make the subchapter S election, a corporation must satisfy several limiting criteria.⁴⁴ Second, subchapter S is less flexible than subchapter K. Allocations must be made in accordance with each shareholder's pro rata share of the corporation,⁴⁵ and the corporation's liabilities do not increase shareholders' stock basis.⁴⁶ Third, subchapter S directs all issues not addressed by subchapter S to subchapter C's double-taxing clutches—such as subchapter C's corporate liquidation provisions.⁴⁷ In sum, subchapter S is no longer the "preferred choice" for the majority of private businesses.⁴⁸

2. Classification

Now that corporate and partnership taxation have been summarized, it is easy to understand why many parties to a business desire to be classified as a partnership for tax purposes. But historically classification as corporation or partnership has been left to the arbitrary and confusing classification provisions in the Code and Treasury Regulations.

Section 7701 of the Code classifies business organizations as either a

40. See I.R.C. § 731(a) (1) (1999).

41. See I.R.C. § 704(d) (1999).

42. See I.R.C. § 1361(a)(1) (1999).

43. See I.R.C. §§ 1361-79 (1999).

44. Specifically, the corporation must not: (1) have more than 75 shareholders; (2) have a shareholder who is not an individual; (3) have a nonresident alien as a shareholder; and (4) have more than one class of stock. See I.R.C. § 1361(b)(1) (1999). Recent trends indicate a congressional attempt to make subchapter S more desirable to closely held corporations by relaxing these criteria. See I.R.C. §§ 1361(c)(1), 1361(c)(2), 1361(c)(5), 1362(f) (1999); see also 2 EDWIN T. HOOD & JOHN J. MYLAN, FEDERAL TAXATION OF CLOSE CORPORATIONS, § 24:01 (1997) [hereinafter 2 HOOD & MYLAN]; Walter D. Schwidetzky, *Is it Time to Give the S Corporation a Proper Burial*, 15 VA. TAX REV. 591, 594-96 (1996).

45. See I.R.C. § 1366(a) (1999). "Each shareholder's pro rata share of [income, gain, loss, and deductions] for any taxable year of the S corporation is determined on a per share, per day basis." 2 HOOD & MYLAN, *supra* note 44, § 24:14. See Treas. Reg. § 1.1377-1 to -3 (1996). Although there are planning techniques to vary this treatment (e.g., employee compensation or rent payments to shareholders), subchapter S does not offer nearly the same degree of flexibility as subchapter K. See Schwidetzky, *supra* note 44, at 596.

46. See I.R.C. §§ 752(a), 752(b), 722, 733(1), 750(a)(2) (1998); Treas. Reg. §§ 1.752-1, -2, -3 (1998); see also Schwidetzky, *supra* note 44, at 597-98.

47. See I.R.C. § 1371(a) (1999). Thus, an "S Corporation" would look to the corporate liquidation rules of Subchapter C, which would cause the corporation, and thus the shareholders, to recognize any gain on the liquidation. See I.R.C. §§ 331, 336 (1999); see also *infra* text accompanying notes 348-53.

48. See Schwidetzky, *supra* note 44, at 592.

(1) corporation⁴⁹ or (2) partnership.⁵⁰ The term partnership includes any unincorporated organization that is not a corporation within the meaning of section 7701.⁵¹ The term corporation, however, includes "associations," which can include unincorporated organizations.⁵² The Code leaves further definition of corporation and partnership to the Treasury.⁵³

a. The *Kintner* Regulations

The crux of the classification debate has been which unincorporated organizations are "associations" under the Code and which are partnerships. The *Kintner* regulations,⁵⁴ named after the Ninth Circuit decision *United States v. Kintner*,⁵⁵ classified an unincorporated organization as an association for tax purposes "if it [had] more corporate than noncorporate characteristics."⁵⁶ There were four criteria for determining whether an unincorporated organization more closely resembled a partnership or a corporation: (1) continuity of life,⁵⁷ (2) free transferability of interests,⁵⁸

49. See I.R.C. § 7701(a)(3) (1999).

50. See I.R.C. § 7701(a)(2) (1999).

51. See *id.*

52. See I.R.C. § 7701(a)(3) (1999).

53. See I.R.C. § 7701(l) (1999).

54. See Treas. Reg. §§ 301.7701-1 (as amended in 1977), 301.7701-2 (as amended in 1993), 301.7701-3 (as amended in 1995).

55. 216 F.2d 418 (9th Cir. 1954). See also Treas. Reg. § 301.7701-2 (as amended in 1993).

56. Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW 378, 424 (1992) [hereinafter Keatinge et al. *A Study of the Emerging Entity*]. See Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993).

57. "An organization [had] continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member [did] not cause a dissolution of the organization." Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993). These triggering events alter the identity of the entity by changing the relationship between the members or partners. Hence, continuity of life did not exist in a limited partnership if the withdrawal of a general partner caused dissolution. See *id.* This is true "notwithstanding the fact that a dissolution . . . may be avoided, . . . by the remaining general partners agreeing to continue the partnership." Treas. Reg. § 301.7701-2(b) (as amended in 1993). Corporations, by contrast, have continuity of life because they have "a continuing identity which is detached from the relationship between its stockholders." Treas. Reg. § 301.7701-2(b)(2) (as amended in 1993).

58. An organization had free transferability of interests "if each of its members or those members owning substantially all of the interests in the organization [had] the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization." Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993). The member must have been able "to confer upon his substitute all the attributes of his interest in the organization." *Id.* Thus, free transferability of interest did not exist if a member could transfer financial interests but not powers in management. See *id.*

(3) centralization of management,⁵⁹ and (4) limited liability.⁶⁰ An organization having more than two of these characteristics was classified as an "association" for federal tax purposes.⁶¹

The *Kintner* regulations prompted legislatures to adopt new statutes that would allow for the benefits of incorporating and the tax advantage of being classified as a partnership.⁶² Also, transactional attorneys began drafting agreements that purposely failed two of the four characteristics in the *Kintner* regulations in order to be classified as a partnership.⁶³

b. The Check-the-Box Regulations

The check-the-box regulations replaced the *Kintner* regulations with a simplified format, which allows parties in an unincorporated business to choose the entity's tax classification: partnership or association.⁶⁴ In so doing, the Treasury withdrew the complicated four-part test and replaced it with a simple form that must be filed with the Internal Revenue Service (the "Service").⁶⁵

Treasury first alerted taxpayers that it was considering check-the-box regulations in Notice 95-14⁶⁶ and initially proposed them in May 1996.⁶⁷ On January 1, 1997, the check-the-box regulations were implemented.⁶⁸

59. "An organization [had] centralized management if any person (or any group of persons which [did] not include all the members) [had] continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed." Treas. Reg. § 301.7701-2(c)(1) (as amended in 1993). The regulations indicated that larger organizations were more likely to have centralized management than smaller organizations. *See id.* The managers need not have been members of the organization. *See* Treas. Reg. § 301.7701-2(c)(2) (as amended in 1993). Furthermore, the regulations stressed that authority must be exclusive and ratification by the members of the organization was not necessary. *See* Treas. Reg. § 301.7701-2(c), (3) (as amended in 1993).

60. An organization had limited liability if "there [was] no member who [was] personally liable for the debts of or claims against the organization." Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993). Limited liability comes in a variety of flavors. For instance, the Texas LLP provides a limited set of liability protections, but the Texas LLC provides more of a corporation-like limited liability. *See* Paul R. Erickson & Buddy J. Sanders, *Assessing LLCs v. LLPs*, 28 TEX. TECH. L. REV. 1005, 1014-17 (1997) [hereinafter Erickson & Sanders] (comparing the Texas LLC and LLP).

61. Additionally, most states used—and some still use—the *Kintner* Regulations for state tax classification purposes. *See infra* text accompanying notes 370-75.

62. *See* Keatinge et al., *A Study of the Emerging Entity*, *supra* note 56, at 432-30.

63. *See* Tassma A. Powers & Deby L. Forry, Comment, *Partnership Taxation & The Limited Liability Company: Check Out the Check-the-Box Entity Classification*, 32 LAND & WATER L. REV. 831, 847-48 (1997) [hereinafter Powers & Forry] ("Prior to the check-the-box regulations, articles of organizations and operating agreements were strategically drafted to avoid being classified as associations. An inordinate amount of time, energy, and resources were used in attempting to draft articles of organization which lacked two of the four corporate resemblance factors."); *see also* 3 ROBERT L. WHITMIRE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS: STRUCTURING AND DRAFTING AGREEMENTS* §§ 2.01 - 2.04 (2d ed. 1996) [hereinafter WHITMIRE].

64. *See* Treas. Reg. § 301.7701-3 (1998).

65. *See* Treas. Reg. § 301.7701-3(c) (1998).

66. Notice 95-14, 1995-1 C.B. 297.

67. *See* 26 C.F.R. §§ 301.6109-1, 301.7701-1 to -4, -6 to -7 (1999).

68. *See* Treas. Reg. §§ 301.7701-1 (1996), 301.7701-2 (1996), 301.7701-3 (as amended in 1997).

In the preamble to its announcement of check-the-box, Treasury cited "historic differences under local law between partnerships and corporations" as the reason that the *Kintner* regulations were a necessary part of federal tax law.⁶⁹ But the "traditional distinctions" between corporations and partnerships under state law have narrowed "considerably."⁷⁰ The advent of unincorporated organizations and partnerships that possess the characteristics traditionally associated with corporations caused the Treasury to replace the "increasingly formalistic rules" with a simplified election.⁷¹

The following describes the mechanics of the check-the-box regulations. Under section 301.7701-2, business entities can either be classified as corporations or partnerships for federal taxation purposes.⁷² A business entity is considered a corporation if: (1) the entity is organized under a state incorporation statute;⁷³ (2) the entity is an association under section 301.7701-3;⁷⁴ or (3) the entity falls in a variety of other miscellaneous classifications.⁷⁵ The check-the-box regulations do not permit these business organizations to choose their own classifications. Thus, such organizations *must* be classified as a corporation.

Any entity other than those listed in section 301.7701-2 is eligible to choose its classification under section 301.7701-3.⁷⁶ An "eligible entity" may elect to be classified as a partnership or as an "association" (i.e., a corporation under section 301.7701-2(b)(2)).⁷⁷ A newly-formed domestic eligible entity that does not file an election will automatically be classified as a partnership if it has two or more members.⁷⁸ Existing eligible entities will, however, not be automatically reclassified under the default

69. Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989 (1996).

70. *Id.* at 21,989-90.

71. *Id.* at 21,990.

72. "Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." Treas. Reg. § 301.7701-1(a) (as amended in 1996). To be classified as a partnership, the business entity must have at least two or more members. If there is only one member then the entity is classified as a corporation or it is disregarded. If the single member chooses to be disregarded, "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." Treas. Reg. §§ 301.7701-2(a), 7701-2(c)(2) (as amended in 1996).

73. *See* Treas. Reg. § 301.7701-2(b)(1) (as amended in 1996).

74. *See* Treas. Reg. § 301.7701-2(b)(2) (as amended in 1996).

75. *See* Treas. Reg. §§ 301.7701-2(b)(3) to 7701-2(b)(7) (as amended in 1996). The list includes joint stock companies, insurance companies, certain banking organizations, state-owned companies, and any other entity that is taxable as a corporation under any other section in the Code. Section 301.7701-2(b)(8) lists certain foreign entities, by country, that will be classified as a corporation. *See* Treas. Reg. § 301.7701-2(b)(8) (as amended in 1996).

76. *See* Treas. Reg. § 301.7701-3 (1998).

77. *See* Treas. Reg. § 301.7701-3(a) (1998). A business entity with "a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner." *Id.*

78. *See* Treas. Reg. § 301.7701-3(b)(1) (1998). The default rule for entities with one member is to disregard the entity and treat it like a sole proprietorship.

rules.⁷⁹ They may, however, elect to change their status.⁸⁰

The check-the-box regulations make the resemblance test under the *Kintner* regulations obsolete.⁸¹ States can now reexamine their intentions for creating their existing statutory schemes. Likewise, LLCs can now freely structure their agreements to the limits of state law without the threat of double taxation.⁸²

B. AN ANALYSIS OF THE HODGEPODGE OF BUSINESS ORGANIZATIONS

Before a comprehensive recommendation on the future of business enterprises can be made, each entity must be analyzed individually. This Section evaluates the strengths and weaknesses of the most popular business entities: the traditional corporation, general partnership, limited partnership, close corporation, LLP, and LLC.

1. Corporations

Traditional corporations were structured to suit large and publicly held enterprises.⁸³ There are four fundamental characteristics of a corporation. First, a corporation is centrally managed through a board of directors for the benefit of passive shareholders.⁸⁴ Material decisions in the operations of a corporation are made by the board of directors and the officers of the corporation.⁸⁵

79. See Treas. Reg. § 301.7701-3(b)(3) (1998).

80. See Treas. Reg. § 301.7701-3(c) (1998) (describing the election procedures under the check-the-box regulations).

Generally, an eligible entity would file a form with the appropriate service center, and a copy of the election form would be included with the entity's tax return for the year the election is effective. Unanimous consent of an entity's membership would not be required: an election could be signed by either all the members or an authorized officer, manager, or owner.

Internal Revenue Service, *Advance Copies of Regulations: Proposed "Check-the-Box" Regs Issued*, 71 TAX NOTES 881, 881 (1996). Also, once an election is made, it cannot be changed for sixty months. See Treas. Reg. § 301.7701-3(c)(iv) (1998).

81. See *Check-the-Box and Beyond*, *supra* note 6, at 610 ([William Callison] suggesting the *Kintner* regulations have "become irrelevant and the undergrowth of interpretive law has been cleared out in favor of bright line rules.").

82. While the threat of double taxation has been removed at the federal level, there remain additional considerations before an LLC takes full advantage of centralized management, continuity of life, and transferability of interest. For example, state taxation may still influence choice-of-entity decisions if states do not conform with the federal check-the-box style of classification. See *infra* text accompanying notes 370-75. Also, state and federal courts may be more prone to call an interest in an LLC a security if the LLC has centralized management with passive investors similar to the limited partnership or corporation. See *infra* note 216.

83. See 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 7:02 (2d ed. 1995) [hereinafter 2 O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS] ("Traditional statutory and judicial norms of corporate law are oriented toward large, publicly held corporations and presume a separation of function between shareholders, who provide the capital, and directors and officers who supply management.").

84. See, e.g., DEL. CODE ANN. tit. 8, § 141 (1991 & Supp. 1998).

85. For example, employment and salary decisions and timing and amounts of dividends are decisions controlled by the board of directors. These corporate powers are typi-

Second, corporate stock is freely transferable.⁸⁶ Free transferability tends to make stock more marketable. Historically, restrictions on transfer were unenforceable⁸⁷ or narrowly interpreted⁸⁸ by courts. In any event, absolute restrictions (i.e., restrictions requiring shareholders' unanimous approval) on transfer are not permissible.

Third, corporations have continuity of life, unless it is otherwise agreed that the corporation will only exist for a specified term. A corporation can dissolve with shareholders' approval.⁸⁹

Fourth, and the corporation's centerpiece, is the limited liability it offers to shareholders.⁹⁰ Historically, limited liability attracted closely held businesses to the corporate form—despite the drawbacks of double taxation and free transferability of stock.⁹¹

These characteristics—limited liability, free transferability of interest, centralized management, and continuity of life—are, to many organizations, tremendous benefits of incorporation, but they can also be undesirable.⁹² For instance, free transferability of stock may cause a shareholder to lose his share of control or may force the shareholder to do business with someone he dislikes or distrusts.⁹³ Limited liability may also hinder the corporation's ability to obtain financing in that it "seems to limit the credit line available to the corporation to that justified by its own assets without resort to those of the stockholders."⁹⁴ Additionally, double taxation may make the corporate form undesirable,⁹⁵ and check-the-box regulations do not alleviate this concern since state law corporations are always subject to corporate classification.⁹⁶

2. General Partnerships

A general partnership is an "association of two or more persons to carry on as co-owners a business for profit."⁹⁷ Partnerships vary in significant ways from corporations. States regulate corporations by requiring

cally of much interest to the shareholder of a close corporation. See 2 O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS, *supra* note 83, § 7:02.

86. See, e.g., DEL. CODE ANN. tit. 8, § 201 (1991).

87. See, e.g., Rafe v. Hindin, 288 N.Y.S.2d 662, 665 (N.Y. App. Div. 1968), *aff'd mem.*, 244 N.E.2d 469 (N.Y. 1968).

88. See, e.g., Frandsen v. Jensen-Sundquist Agency, Inc., 802 F.2d 941, 946 (7th Cir. 1986).

89. See, e.g., DEL. CODE ANN. tit. 8, § 275 (1991).

90. See CHESTER ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 2A.011 (John P. O'Brien et al. eds., 5th ed. 1975).

91. See *id.* §§ 2A.011, .01[3], .03.

92. See *id.* § 2A.01[2].

93. See *id.* § 2A.04.

94. *Id.* § 2A.01[2](1).

95. See *supra* text accompanying notes 24-48.

96. See Treas. Reg. § 301.7701-2(b)(1) (as amended in 1996); see also *supra* text accompanying notes 72-80.

97. UNIF. PARTNERSHIP ACT § 6(1) (1914 Act), 6 U.L.A. 256 (1995) [hereinafter UPA]; see also UNIF. PARTNERSHIP ACT § 202(a) (1994), 6 U.L.A. 27 (1995) [hereinafter RUPA].

an initial filing⁹⁸ and compliance with corporate formalities (such as maintaining a board of directors and conducting annual meetings).⁹⁹ In partnership law, two or more persons who “carry on” a business together create a partnership; no state filing is required. Further, there are no required formalities for a partnership.¹⁰⁰

In a partnership, liability is not limited;¹⁰¹ management is decentralized with each partner receiving one vote;¹⁰² and interest in the partnership is not freely transferable.¹⁰³ Moreover, a partnership dissolves if one of the partners disassociates with the firm, dies, or declares bankruptcy.¹⁰⁴ The Revised Uniform Partnership Act (RUPA) added that a partnership will dissolve if a partner “has otherwise become incapable of performing.”¹⁰⁵ Management rules and transferability restrictions, of course, can each be altered by agreement.¹⁰⁶

To many closely held firms, general partnership characteristics like restrictions on transferability of interest, lack of continuity of life, and member management are desirable. Pass-through taxation is another desirable attribute of the partnership.¹⁰⁷ But many closely held firms are unwilling to accept full liability for fellow partner’s actions.

3. Limited Partnerships

Limited partnerships have two main characteristics in common with the general partnership form. First, with a few restrictions,¹⁰⁸ limited part-

98. See, e.g., DEL. CODE ANN. tit. 8, §§ 101 - 110 (1991 & Supp. 1996).

99. See, e.g., *id.* §§ 141, 211-31. Failure to follow these formalities can result in piercing the corporate veil. See ROHRLICH, *supra* note 90, § 2A.06[1].

100. See 1 ALLAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 2.01(a) (1997) [hereinafter BROMBERG & RIBSTEIN ON PARTNERSHIP]. While there are no requisite formalities in the formation or operation of a partnership, the partners may want to consider writing a partnership agreement, registering the business name, and procuring necessary licenses or registrations. See *id.*

101. See UPA, *supra* note 97, §§ 9(1), 15.

102. See *id.* § 18(e).

103. The only transferable interest in a partnership is the financial share. See *id.* §§ 26, 27. Transfer of an interest does not entitle the receiver of the interest to participate in management of the partnership. See *id.*

104. See UPA, *supra* note 97, § 31

105. RUPA, *supra* note 97, § 601.

106. See UPA, *supra* note 97, § 18.

107. See *supra* text accompanying notes 31-36.

108. The main restriction on limited partnerships as compared to general partnerships concerns allocations. For an allocation to comply with section 704, it must have substantial economic effect. See Treas. Reg. § 1.704-1(b)(2) (as amended in 1997); see also *supra* note 37. One requirement of the economic effect test is that partners must be unconditionally obligated to restore a deficit in their capital accounts. See Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1997). This restoration obligation exists because limited partners are not obligated to restore a deficit in their capital accounts. See REVISED UNIF. LTD. PARTNERSHIP ACT § 303(a) (1976), 6A U.L.A. 1 (1995) [hereinafter RULPA]. The allocation must meet the alternate test for economic effect. The alternate test requires that the limited partnership (1) properly maintain partners’ capital accounts, (2) liquidate in accordance with positive capital accounts, and (3) not make an allocation that would push any limited partner’s capital account into a deficit. See Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 1997); Treas. Reg. §§ 1.704-1(b)(2)(ii)(c)(1), 1.704-1(b)(5) example (1) (as amended in 1997). The alternate test also requires that the partnership agreement include a “qualified

nerships receive pass-through taxation as well as the other benefits of taxation under subchapter K.¹⁰⁹ Second, general partners have no protection from the limited partnership's liabilities.¹¹⁰

But limited partnerships differ from general partnerships in several ways. First, and most notably, limited partners are shielded from liability for obligations of the limited partnership.¹¹¹ Second, unlike partners in a general partnership, a limited partner may exercise only limited control over the limited partnership.¹¹² Exerting too much control can expose a limited partner to personal liability as if he were a general partner.¹¹³ Third, because of their limited liability protection, limited partnerships must file with the state¹¹⁴ and must adhere to certain formalities.¹¹⁵

However, the limited partnership form allows capital and service providers to structure unique agreements whereby a passive investor (i.e., the limited partner) can have rights to profits of the business without being liable for the losses.¹¹⁶ A limited partnership agreement will often require an initial capital contribution from the limited partners with minimal contribution from the general partner.¹¹⁷ Limited partners will also frequently receive a large percentage of the distributions at first, although perhaps tapering off at the end when financial objectives are attained.¹¹⁸ "On the winding up of the partnership, the assets are distributed to the partners according to their capital accounts."¹¹⁹

The growth of limited partnerships has been due especially to "their use as hoped-for tax shelters. Limited partnerships have been particularly popular where the tax advantages of depletion and depreciation, income deferral, and ultimate capital gain treatment—combined with limited liability—have been most attractive . . ."¹²⁰ But many of the advantages to the tax shelter have been taken away one-by-one by Congress and Treasury.¹²¹

income offset" provision, which requires the partnership to allocate the first amount of income to a limited partnership if an unexpected cash distribution pushes the limited partner's capital account below zero. See Treas. Reg. § 1.704(b)(2)(ii)(d) (as amended in 1997).

109. See *supra* text accompanying notes 31-41.

110. See RULPA, *supra* note 108, § 403.

111. See *id.* § 303(a).

112. Limited partners may exert some control over the limited partnership. For example, RULPA provides a safe harbor that allows a limited partner to consult with and advise the general partner on the business of the limited partnership. See *id.* § 303(b)(2).

113. See *id.* § 303(a). However, the limited partner is only liable to third parties who reasonably believe, based on the limited partner's conduct, that he is a general partner. See *id.*

114. See *id.* §§ 201-08.

115. See, e.g., *id.* §§ 105, 209. See generally BROMBERG & RIBSTEIN ON PARTNERSHIP, *supra* note 100, § 11.01(b).

116. See BROMBERG & RIBSTEIN ON PARTNERSHIP, *supra* note 100, § 11.02.

117. See *id.*

118. See *id.*

119. *Id.*; see also Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 1997).

120. BROMBERG & RIBSTEIN ON PARTNERSHIP, *supra* note 100, § 11.01(f).

121. There are now four hurdles that must be overcome for a limited partnership to recognize a loss. First, allocations in a limited partnership must meet the alternate test for economic effect. See Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 1997). In order to

Limited partnerships have also been the traditional favorite of tax planners for family tax planning.¹²² There are generally two uses for family limited partnerships. First, family limited partnerships have commonly been used to minimize income taxes in families that want to pass the family business from generation to generation.¹²³ Parents, presumably in high tax brackets, make annual gifts of partnership interests to the children in lower tax brackets.¹²⁴ Parents should make gifts up to the maximum gift tax exclusion, which is \$10,000 per donee per year or \$20,000 per year for spouses.¹²⁵ "As gifts are made, the income which would have been reported on the parent's income tax return, at a high marginal income tax rate, is now reported on the children's income tax return, at a lower marginal income tax rate."¹²⁶ Thus, the net taxes paid by the family are lower.

Second, tax planners use the family limited partnership as an estate planning tool.¹²⁷ Here, a parent contributes assets or the family business to a limited partnership.¹²⁸ Gifting programs similar to the one mentioned above are used to lower income taxes in life. A gift of a limited partnership interest allows the parent to maximize tax savings without relinquishing control over assets (since the gifts are limited partnership units).¹²⁹ When the parent dies, the estate owns partnership units instead of the assets that were contributed. Moreover, restricted transferability

meet this test, generally the partnership cannot make an allocation that would push a limited partner's capital account into a deficit. *See id.* Second, limited partners may recognize a loss only to the extent of their outside basis. *See* I.R.C. §§ 704(d), 705(a)(2) (1999). Third, limited partners can deduct a loss only to the extent that the partner is at risk with the activity at the end of the partnership year. *See* I.R.C. § 465 (1999). Fourth, passive losses can only be offset by passive income. *See* I.R.C. § 469 (1999).

122. *See generally* HENKEL, *supra* note 14, §§ 15-16; MARK A. SARGENT & WALTER D. SCHWIDETZKY, *LIMITED LIABILITY COMPANY HANDBOOK* ch. 4 (1998); Travis L. Bowen & Rick D. Bailey, *Limited Partnerships: Use in Tax, Estate and Business Planning*, 32 *IDAHO L. REV.* 305 (1996) [hereinafter Bowen & Bailey].

123. The benefits of family limited partnerships are not limited to taxation. There are also significant business benefits, including (1) pooling assets and investments earn the family economies of scale, (2) placing assets in such an entity protects the assets from creditors, and (3) gifting limited partnership units to younger family members facilitates passing the business from generation-to-generation. *See generally* HENKEL, *supra* note 14, §§ 15-16; Bowen & Bailey, *supra* note 122, at 326-27.

124. *See* I.R.C. § 2503(b) (1999); *see also* HENKEL, *supra* note 14, § 16.03; Bowen & Bailey, *supra* note 122, at 326-29.

125. *See* I.R.C. § 2503(b) (1999); *see also* Bowen & Bailey, *supra* note 122, at 328-29.

126. Bowen & Bailey, *supra* note 122, at 326.

127. *See* HENKEL, *supra* note 14, §§ 15-16; Bowen & Bailey, *supra* note 122.

128. *See* HENKEL, *supra* note 14, §§ 15-16; Bowen & Bailey, *supra* note 122, at 330-33.

129. *See* Bowen & Bailey, *supra* note 122, at 331. The parent can retain control over the assets by naming themselves the general partner. But naming only one general partner can be troublesome. For example, if the parent becomes incapacitated, the partnership will dissolve. *See* HENKEL, *supra* note 14, § 16.02[1][a][ii]. More than one general partner, however, also has disadvantages. Any general partner can bind the partnership, and more than one control person can lead to disagreement over the affairs of the business. Also, each general partner will be liable for the obligations of the partnership. *See* HENKEL, *supra* note 14, § 16.02[1]. *Cf.* HENKEL, *supra* note 14, § 16.02[1][e][iii] (noting the difficulties unique to using an LLC as general partner). These factors (and others) must be considered prior to formation of the partnership.

and the lack of management rights, combined with continuity of life, reduce the marketability of the partnership interest.¹³⁰ Thus, the gross estate will be valued at a lesser amount because the partnership units have a lower value than the underlying assets in the partnership.

But the limited partnership still has two disadvantages: (1) the full personal liability of the general partner¹³¹ and (2) the potential for liability exposure to a limited partner that exercises too much control over the business.¹³² For example, such liability can come in the form of lawsuits from employees, customers, creditors, regulators, or anyone else who might have a cause of action.¹³³ General partners may also be sued by the limited partners if the limited partnership is not as successful as promised.¹³⁴ Thus, these two disadvantages are serious flaws with the limited partnership form.¹³⁵

4. *Close Corporations*¹³⁶

For many years, corporation law paid little attention to closely held

130. This must be done according to the Code's valuation rules in Chapter 14. See I.R.C. §§ 2701-04 (1999); see also HENKEL, *supra* note 14, § 16.03; Bowen & Bailey, *supra* note 122, at 333-36; Edwin T. Hood et al., *Valuation of Closely Held Business Interests*, 65 UMKC L. REV. 399, 479-83 (1997); D. John Thornton & Gregory A. Byron, *Valuation of Family Limited Partnership Interests*, 32 IDAHO L. REV. 345 (1996).

131. See RULPA, *supra* note 108, § 403. Some states have attempted to lessen the liability risks associated with the limited partnership. For example, some states give general partners limited liability through their LLLP statute, but only a few states have this option. See, e.g., COLO. REV. STAT. ANN. §§ 7-64-1001 to 1010 (West 1999); DEL. CODE ANN. tit. 6, § 17-214 (Supp. 1996). See generally ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT §§ 5.01-5.05 (1998) [hereinafter BROMBERG & RIBSTEIN ON LLPs]; Keatinge et al., *Limited Liability Partnerships*, *supra* note 13, at 196-207. Also, practitioners will often protect the general partner by forming an S Corporation or single-member LLC, each of which give the general partner liability protection and pass-through taxation. See Bowen & Bailey, *supra* note 122, at 309-10; Alan Waldman, *New Statute Brings Benefits to Real Estate Companies*, L.A. BUS. J., Oct. 24, 1994, at A-17; see also *supra* notes 42-48. But these are, nevertheless, stop-gap measures to make the limited partnership accommodate the business purposes of the entity.

132. See UNIF. LTD. PARTNERSHIP ACT, § 7 (1916), 6A U.L.A. 336 (1995) [hereinafter ULPA]. Although the RULPA increased the control limited partners can exert without jeopardizing their liability protections, the limited partners are nevertheless still limited in their ability to control the affairs of the business. See RULPA, *supra* note 108, § 303.

133. See *Executive Risk Reintroduces Its GP Liability Policy*, NAT'L UNDERWRITER (Property & Casualty/Risk & Benefits Management Edition) Sept. 1, 1997, at 17.

134. See *id.*

135. But Professor Bernard Black has argued that the limited partnership's inertia may keep it on the books well into the future, despite its disadvantages. See *Check-the-Box and Beyond*, *supra* note 6, at 611.

136. There is disagreement over the precise definition of the close corporation. One view proposes that the close corporation is one which the "management and ownership are substantially identical to the extent that it is unrealistic to believe that the judgment of the directors will be independent of that of the stockholders." Symposium, *The Close Corporation*, 52 Nw. U. L. REV. 345, 345 (1957) [hereinafter Symposium]. Another view defines the critical attributes of a close corporation as "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation . . ." *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 511 (Mass. 1975). Others have focused on the lack of a public market for the corporation's stock, thereby focusing on "illiquidity." See Steven C. Bahls, *Resolving*

enterprises and focused instead on much larger businesses.¹³⁷ Before the 1940s, small corporations that varied their corporate structure by agreement to meet their unique needs were often unable to enforce such agreements in court.¹³⁸ The close corporation was one of the first attempts to combine the favorable characteristics of partnership law with corporation law.¹³⁹ Limited liability, and at one time favorable federal taxation,¹⁴⁰ attracted closely-held firms to the corporate form.¹⁴¹ But closely-held firms preferred “to retain internally the partnership form of doing business.”¹⁴²

Beginning in the 1940s and 1950s, states began to develop special rules within corporation statutes for corporations with few shareholders.¹⁴³ Many states amended their state’s general corporation statute, “ostensibly available to all corporations, but of the greatest use to close corporations.”¹⁴⁴ Some states chose to create an independent statute specifically available to the close corporation.¹⁴⁵

One undesirable quality of traditional corporation law for the close corporation was the unrestricted transfer of interests:¹⁴⁶

Whereas the owners of close corporations are prepared to accept as good the “permanence” of the corporation and the fact that the death or incapacity of any of them does not bring about its dissolution, they are quite unwilling to accept the free transferability of corporate stock whereby strangers may be foisted upon them.¹⁴⁷

Restrictions on the transfer of interests are of vital importance to close corporations. “[B]ecause of the coalescence between ownership and management, it is necessary that each close-incorporator have the utmost confidence in the integrity and business judgment of his fellow sharehold-

Shareholder Dissension: Selection of the Appropriate Equitable Remedy, 15 J. CORP. L. 285, 288-89 n.23 (1990). While a precise definition is perhaps unattainable, each attempt sheds light on the characteristics of a close corporation.

137. See 1 F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S CLOSE CORPORATIONS: LAW AND PRACTICE § 1.13 (3d ed. 1998) [hereinafter O’NEAL’S CLOSE CORPORATIONS]. In fact, courts treated with hostility those close corporations that attempted to modify the traditional corporate rules. “[Partners that incorporate] cannot be partners inter sese and a corporation as to the rest of the world.” *Jackson v. Hooper*, 75 A. 568, 571 (N.J. 1910).

138. See O’NEAL’S CLOSE CORPORATIONS, *supra* note 137, § 1.13.

139. See *id.*; Symposium, *supra* note 136, at 347-52; see also ROHRLICH, *supra* note 90, § 2A.03.

140. Prior to the 1980s, the corporate equity was often preferable from a tax perspective. Tax reform throughout the 1980s, however, virtually eliminated the desirability of the corporate form from a tax perspective. See O’NEAL’S CLOSE CORPORATIONS, *supra* note 137, § 1.13. Certain close corporations, however, could still qualify for an S election, which would tax the shareholders on a flow-through basis. See *supra* text accompanying notes 42-48.

141. See O’NEAL’S CLOSE CORPORATIONS, *supra* note 137, § 1.13.

142. ROHRLICH, *supra* note 90, § 2A.03.

143. See, e.g., DEL. CODE ANN. tit. 8, §§ 341-56 (1991). Some of the first states to do so were Illinois, Indiana, and New York. See Symposium, *supra* note 136, at 348 n.12.

144. O’NEAL’S CLOSE CORPORATIONS, *supra* note 137, § 1.13.

145. See *id.*

146. See *id.* § 1.14.

147. ROHRLICH, *supra* note 90, § 2A.04.

ers."¹⁴⁸ Also, shareholders of the close corporation will be wary of competitors purchasing stock or one shareholder purchasing a majority of outstanding shares.¹⁴⁹

Authorization of share transfer restrictions is one of the more common adjustments made to corporate law in an effort to accommodate close corporations.¹⁵⁰ Many states view restricted transferability as an essential element to qualify as a close corporation.¹⁵¹ In fact, most states modified their general corporation law to provide for transferability.¹⁵² For example, Maryland's close corporation statute restricts transferability as a default rule.¹⁵³

Centralized management by a board of directors is another traditional rule that was inconsistent with close corporations because it conflicted with the interests of minority shareholders.¹⁵⁴ For example, in the event of disagreement, a minority shareholder may not be able to effectively protect himself next to a shareholder who owns a majority of stock.¹⁵⁵ Also, many investors in close corporations anticipate being employed by the corporation,¹⁵⁶ and employment decisions are often left to the discretion of centralized management, with the protections of the business judgment rule.¹⁵⁷ "Statutes in all states now permit participants in close corporations to depart from the statutory norm and restrict the centralized control of directors."¹⁵⁸

In addition to the preceding examples, states have also added provisions that modify continuity of life and allow remedies for dissension.¹⁵⁹ Also, many states have relaxed the requirements of traditional corporate formalities.¹⁶⁰

Despite the accommodations states have made, the close corporation presents unnecessary complexities for the practitioner, as well as unsettling risks for the client. A businessperson is straddled with the burden of "costly and detailed planning" required in conforming the closely held

148. *Id.* at § 2A.07.

149. *See id.*

150. *See* O'NEAL'S CLOSE CORPORATIONS, *supra* note 137, § 1.14. In the close corporation, restrictions on transferability were seen as a restraint on alienation. In fact, no jurisdiction allows for an absolute restriction on transferability. *See* 1 WILLIAM H. PAINTER, PAINTER ON CLOSE CORPORATIONS: CORPORATE, SECURITIES, AND TAX ASPECTS § 3.1.1 (3d ed. 1997) [hereinafter PAINTER ON CLOSE CORPORATIONS]. As such, shareholders in a close corporation must make the restriction reasonable. *See id.* § 3.1.2.

151. *See* ROHRlich, *supra* note 90, § 2A.07.

152. *See* O'NEAL'S CLOSE CORPORATIONS, *supra* note 137, § 1.14.

153. *See, e.g.,* MD. CODE ANN., CORPS. & ASS'NS § 4-501 (1993). *See generally* O'NEAL'S CLOSE CORPORATIONS, *supra* note 137, § 1.14.

154. *See* DEL. CODE ANN. tit. 8, § 141 (1991 & Supp. 1998).

155. *See* O'NEAL'S CLOSE CORPORATIONS, *supra* note 137, § 1.15.

156. *See id.*

157. *See id.*

158. *Id.*

159. *See id.* § 1.16; *see also infra* text accompanying notes 296-98.

160. *See* O'NEAL'S CLOSE CORPORATIONS, *supra* note 137, § 1.17.

company to the corporate form.¹⁶¹ Even after expensive lawyer bills, the client could still face disastrous consequences:

[Where] planning is imperfect, as it so often is in closely held firms, the standard corporate default rules are ready to strike. Unwary minority members may be frozen into an economically inferior position. The cure for this may be worse than the disease—subjecting the firm to ad hoc judicial remedies that tend to ignore the deals the parties actually have made.¹⁶²

The costs and risks, including the threat of possible double taxation,¹⁶³ associated with the close corporation make the form less desirable to many closely held firms.¹⁶⁴

5. *Limited Liability Partnerships*

Several states created the limited liability partnership (LLP) in the wake of the savings and loan scandals.¹⁶⁵ The federal government, through the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC), was looking for deep pockets to pay the costs associated with these thrift scandals.¹⁶⁶ Law and accounting firms were the favorite targets for many of the federal lawsuits.¹⁶⁷ Subsequently, across the country innocent partners in professional firms were held liable for the acts of guilty partners within their firms.¹⁶⁸

161. Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 *BUS. LAW.* 1, 2-3 (1995) [hereinafter Ribstein, *Emergence of the LLC*]. Much confusion exists between lawyers and non-lawyers concerning the requirements to become a close corporation. One observer noted that "many lawyers mistakenly believe they may have to elect close corporation status to be eligible to elect the tax status provided by Subchapter S . . . or believe they have to elect such status to come within the 'short form' exemption of the California securities law." O'NEAL'S CLOSE CORPORATIONS, *supra* note 137, § 1.19.

162. Ribstein, *Emergence of the LLC*, *supra* note 161, at 2-3.

163. Many firms can get flow-through taxation via subchapter S, but not all firms will qualify. See *supra* text accompanying notes 42 to 48. While the S election may be available for most small firms, such firms still run the risk of "blowing" the S election. One way this has happened is in the case where a corporation is financed through both debt and equity. If a court were to hold that a debt instrument is actually equity, see, e.g., *Portage Plastics Co., Inc. v. United States*, 486 F.2d 632 (7th Cir. 1973); *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968), the corporation will have two classes of stock, which will disqualify the corporation from using the S election. See I.R.C. § 1361(b)(1)(D) (1999). Although Congress and the Treasury have recently provided safe harbors for corporate debt, this issue underscores one of the S corporation's historical and fundamental flaws. See I.R.C. § 1361(c)(5) (1999); Treas. Reg. § 1.1361-1(l) (as amended in 1995).

164. See Larry E. Ribstein, *The New Choice of Entity for Entrepreneurs*, 26 *CAP. U.L. REV.* 325, 331 (1997) [hereinafter Ribstein, *New Choice of Entity*] ("In the wake of the development of the LLC and the LLP and 'check-the-box' rule there is a new rule of thumb for entrepreneurs who are considering whether to incorporate: Don't.").

165. See BROMBERG & RIBSTEIN ON LLPs, *supra* note 131, § 1.01(a).

166. See Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at Birth (Nearly)*, 66 *U. COLO. L. REV.* 1065, 1069 (1995).

167. See BROMBERG & RIBSTEIN ON LLPs, *supra* note 131, § 1.01(a).

168. See, e.g., M. A. Dornbush, *A Flood of Litigation: Liability Suits Add Up on Accountants*, 12 *AUSTIN BUS. J.* 9 (1992) (reporting that liability for the nation's accounting firms was adding up: Coopers & Lybrand, \$200 million; Arthur Andersen, \$22 million; Ernst & Young, \$63 million; not to mention legal fees and other costs that would be passed on to partners if the partnership money runs out).

Texas law and accounting firms were hit especially hard.¹⁶⁹ It is not surprising that in 1991 Texas was the first to create an LLP statute,¹⁷⁰ which limited partners' liability to their investment in the organization. The statute provided a "partial shield" that limited innocent partners' liability for errors, omissions, negligence, incompetence, or malfeasance of other partners.¹⁷¹ While the Texas statute only covered tort liability, by 1993 several states promulgated LLP statutes extending the liability shield to tort and contract liability.¹⁷²

Today, all fifty states and Washington D. C. have LLP statutes,¹⁷³ and LLP liability protections still vary from state-to-state.¹⁷⁴ Generally, there are three flavors of liability protection in the LLP.¹⁷⁵ First, there is a pure negligence approach, protecting innocent partners from claims of malpractice of other partners in the LLP.¹⁷⁶ Second is the tort and contract approach, which protects innocent partners from claims sounding in tort or contract.¹⁷⁷ Third is the vicarious liability approach, which removes partners' vicarious liability for all types of claims.¹⁷⁸ Most states adhere

169. See Hamilton, *supra* note 166, at 1069 ("More than one-third of all the bank failures in the United States [during the 1980s] occurred in Texas.").

170. See TEXAS UNIF. PARTNERSHIP ACT, ch. 901, § 84, 1991 Tex. Gen. Laws 3161.

171. See generally BROMBERG & RIBSTEIN ON LLPs, *supra* note 131, §§ 1.01-.02 (providing a history of the development of the LLP); Hamilton, *supra* note 166, at 1069 (discussing the history of Texas' LLP statute).

172. Louisiana provided liability protection that included intentional and willful misconduct. See BROMBERG & RIBSTEIN ON LLPs, *supra* note 131, § 1.01. Delaware enlarged the liability shield to cover wrongful acts, misconduct, and negligence. See *id.* By 1994, Delaware limited both tort and contract liability. See *id.*

173. As of the writing of this Comment, there are 46 states and the District of Columbia that have LLP statutes. Arkansas, Rhode Island, Vermont, and Wyoming do not have LLP statutes. See *id.* § 1.01(e).

174. See Bruce P. Ely & Christopher R. Grissom, *The LLC/LLP Scorecard*, 98 TNT 225-72, Nov. 23, 1998, available in LEXIS, FEDTAX Library, TNT File; see also Keatinge et al., *Limited Liability Partnerships*, *supra* note 13, at 175-80; BROMBERG & RIBSTEIN ON LLPs, *supra* note 131, § 3.

175. See Keatinge et al., *Limited Liability Partnerships*, *supra* note 13, at 175-80.

176. See, e.g., TEX. REV. CIV. STAT. ANN. art. 6132b § 3.08(a)(1) (West 1998); see generally Erickson & Sanders, *supra* note 60, at 1014-17.

Five exceptions exist to the limit on liability [in the Texas LLP]. First, a partner remains liable if he directly supervises another partner or representative who commits the "error or omission." . . . Second, a partner is liable if he or she is directly involved in the specific activity where another partner or representative commits the "errors or omissions." . . . Third, a partner is liable if he had notice or knowledge of the misconduct at the time of the occurrence and then "failed to take reasonable steps to prevent or cure" the misconduct. . . . Fourth, partners remain liable for debts and obligations other than "errors and omissions" of partners and representatives. . . . Fifth, even if the "errors and omissions" of one partner preclude another partner from being held liable, the partnership itself is not protected.

Id.; see also Keatinge et al., *Limited Liability Partnerships*, *supra* note 13, at 175-78.

177. See Keatinge et al., *Limited Liability Partnerships*, *supra* note 13, at 178-79; see, e.g., VA. CODE ANN. § 50-15(B) (Michie 1998).

178. See Keatinge et al., *Limited Liability Partnerships*, *supra* note 13, at 179-80; see, e.g., CAL. CORP. CODE § 15018(b) (West Supp. 1999). Cf. BROMBERG & RIBSTEIN ON LLPs, *supra* note 131, § 3.03.

to the latter two approaches.¹⁷⁹

Professor Ribstein has argued that the LLP is well suited for professional firms.¹⁸⁰ First, the LLP's liability shield conforms with the needs of professional firms.¹⁸¹ Second, unlike the limited partnership, LLC,¹⁸² and corporation, which limit distributions, the LLP allows professional firms to pay out all firm income to the partners.¹⁸³

But the LLP form is a good example of the duplication and confusion that exists in business formation.¹⁸⁴ The LLP was a creation of the state legislatures to meet an immediate need facing law and accounting firms.¹⁸⁵ In the current situation, however, the LLP is unnecessary. In fact, it is "a step backward from LLCs because, as a general partnership, it still (i) has the shortcomings of a general partnership, (ii) must have two members, (iii) must be organized to carry on a business for profit, and (iv) is, of business organizations, the most susceptible to dissolution."¹⁸⁶

6. Limited Liability Companies

The history of the LLC demonstrates how closely states have tracked federal tax laws in creating new business entities. In 1977, Wyoming was the first state to pass an LLC statute;¹⁸⁷ in 1982, Florida followed.¹⁸⁸ But

179. See Keatinge et al., *Limited Liability Partnerships*, *supra* note 13, at 178-80; BROMBERG & RIBSTEIN ON LLPs, *supra* note 131, Table 3-1.

180. See Ribstein, *New Choice of Entity*, *supra* note 164.

181. See *id.*

182. See, e.g., N.Y. LTD. LIAB. CO. LAW § 508(a) (McKinney Supp. 1999). The New York LLC limits distributions in the following manner:

A limited liability company shall not make a distribution to a member to the extent that, at the time of the distribution, after giving effect to the distribution, all liabilities of the limited liability company, other than liabilities to members on account of their membership interests and liabilities for which recourse of creditors is limited to specified property of the limited liability company, exceed the fair market value of the assets of the limited liability company, except that the fair market value of property that is subject to a liability for which the recourse of creditors is limited shall be included in the assets of the limited liability company only to the extent that the fair value of such property exceeds such liability.

Id. See also LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES (1992) [hereinafter RIBSTEIN & KEATINGE ON LLCs].

183. See Ribstein, *New Choice of Entity*, *supra* note 164, at 336. Cf. BROMBERG & RIBSTEIN ON LLPs, *supra* note 131, § 4.04(d); Hamilton, *supra* note 166, at 1098-99.

184. See Ribstein, *New Choice of Entity*, *supra* note 164, at 335-36.

185. See *supra* text accompanying notes 131 to 138. Also, political expediency may be one reason the LLP statute developed the way it did. In Texas, for example, it was much easier to pass limited liability language that mirrored the language in the Texas Professional Corporation Act. See Keatinge et al., *Limited Liability Partnerships*, *supra* note 13, at 175-78. Such language was familiar and was not as controversial. See *id.*

186. *Id.* at 207.

187. See Wyoming Limited Liability Company Act, 1977 Wyo. Sess. Laws ch. 158, § 1 (codified at WYO. STAT. ANN. § 17-15-101 to -136 (Michie 1997)).

188. See Florida Limited Liability Company Act, 1982 Fla. Laws ch. 82-177, § 2 (codified at FLA. STAT. ANN. §§ 608.401 to .471).

few LLCs in either state were actually formed.¹⁸⁹ In 1988, the Service issued Revenue Ruling 88-76, which stated that the Service would treat the Wyoming LLC as a partnership for tax purposes.¹⁹⁰ Confirming the demand for a business form with limited liability, flexibility, and favorable federal taxation, Revenue Ruling 88-76 prompted several states to generate LLC statutes.¹⁹¹ Beginning in 1990, Colorado,¹⁹² Kansas,¹⁹³ and Indiana¹⁹⁴ passed LLC statutes.¹⁹⁵ In 1991, Virginia,¹⁹⁶ Utah,¹⁹⁷ Texas,¹⁹⁸ and Nevada¹⁹⁹ enacted LLC statutes.²⁰⁰ As states enacted LLC statutes, each state had a significant number of filings each year thereafter.²⁰¹ "The explosion of LLC law in the few years since 1988 confirm[ed] not only the importance of the tax endorsement, but also the existence of a strong pent-up demand for this form of business."²⁰² Today all fifty states and Washington D.C. have LLC statutes.²⁰³

The LLC is the best-of-all-worlds business form. Members in an LLC have limited liability;²⁰⁴ the check-the-box regulations allow the LLC to choose flow-through taxation;²⁰⁵ and the LLC contains flexible firm management, transferability of interest, and dissolution rules. As for firm management, some LLC statutes provide a default rule that the LLC be run by managers,²⁰⁶ others have member-managed LLC default rules (managers can be selected by agreement),²⁰⁷ and still others require the

189. In fact, prior to 1982 no other state had passed an LLC act and in 1988 there were only twenty-six LLCs in Wyoming. See Joseph P. Fonfara & Corey R. McCool, Comment, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and Limited Partnership?*, 23 LAND & WATER L. REV. 523, 523 (1988).

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

191. See generally Keatinge et al., *A Study of the Emerging Entity*, *supra* note 56, at 381-84.

192. See COLO. REV. STAT. §§ 7-80-101 to -1101 (West Supp. 1999).

193. See KAN. STAT. ANN. §§ 17-7601 to -7650 (1995 & Supp. 1998).

194. See IND. CODE ANN. §§ 23-18-1-1 to -19 (Michie 1999).

195. See generally Keatinge et al., *A Study of the Emerging Entity*, *supra* note 56, at 423-31 (comparing LLC statutes of several states).

196. See VA. CODE ANN. §§ 13.1-1000 to -1069 (Michie 1993).

197. See UTAH CODE ANN. §§ 48-2b-101 to -156 (1998 & Supp. 1999).

198. See TEX. REV. CIV. STAT. ANN. art. 1528n, arts. 1.01-9.02 (West Supp. 1999).

199. See NEV. REV. STAT. ANN. §§ 86.011 to .571 (Michie 1994 & Supp. 1997).

200. See generally Keatinge et al., *A Study of the Emerging Entity*, *supra* note 56, at 423-41.

201. See *supra* note 8.

202. Ribstein, *Emergence of the LLC*, *supra* note 161, at 4.

203. See Powers & Foity, *supra* note 63, at 856-58.

204. RIBSTEIN & KEATINGE ON LLCs, *supra* note 182, § 12.01 ("All the LLC statutes explicitly provide that neither the members nor managers of an LLC are liable for debts, obligations, or other liabilities of the LLC."); see, e.g., WYO. STAT. ANN. § 17-15-113 (Michie 1997) ("Neither the members of a limited liability company nor the managers of a limited liability company managed by a manager or managers are liable under a judgment, decree or order of a court, or in any other manner for a debt, obligation or liability of the limited liability company.").

205. See *supra* text accompanying notes 31-41 and 64-82.

206. See, e.g., TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.12 (West 1997); see also John D. Jackson & Alan W. Tompkins, *Corporations and Limited Liability Companies*, 47 SMU L. REV. 901, 924-25 (1994).

207. See, e.g., DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1996); N.Y. LTD. LIAB. CO. LAW § 401 (McKinney Supp. 1999); CAL. CORP. CODE § 17150 (West Supp. 1998).

organization to choose its management structure in the articles of organization.²⁰⁸ Most LLC statutes require that the LLC dissolve if one of the members dies, retires, resigns, or declares bankruptcy,²⁰⁹ but some statutes have recently deleted such dissolution provisions.²¹⁰ Additionally, many LLC statutes have a default rule that restricts transferability. Many of these default rules require unanimous²¹¹ or majority-in-interest²¹² consent before a member is permitted to transfer a control interest in the LLC.²¹³ Thus, the LLC has combined favorable corporate characteristics with favorable partnership characteristics.

Thousands of individual LLCs now exist in all fifty states.²¹⁴ But there is still some hesitancy among practicing lawyers to recommend the LLC. Uncertainty as to the rules of fiduciary duty,²¹⁵ uncertainty as to whether an LLC interest is a security,²¹⁶ a lack of uniformity from state-to-state,

208. See, e.g., COLO. REV. STAT. ANN. § 7-80-401 (West Supp. 1998); TENN. CODE ANN. § 48-205-101(7) (1995).

209. See, e.g., TENN. CODE ANN. § 48-245-101(5) (1995); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 6.01(5) (West 1997); WYO. STAT. ANN. § 17-15-123(a)(iii) (Michie 1999); N.Y. LTD. LIAB. CO. LAW § 701 (McKinney Supp. 1999).

210. See, e.g., Colo. Laws 1997, S.B. 97-233, § 20, effective June 3, 1997.

211. See, e.g., ALA. CODE § 10-12-31 (1994); ALASKA STAT. § 10.50.165 (Michie 1998); LA. REV. STAT. ANN. § 12:1332 (West 1994).

212. See, e.g., CAL. CORP. CODE § 17303 (West Supp. 1999); FLA. STAT. ANN. § 608.432 (West Supp. 1999); N.Y. LTD. LIAB. CO. LAW § 604 (McKinney Supp. 1998).

213. Financial interests, however, are transferable. See, e.g., COLO. REV. STAT. ANN. § 7-80-702 (West Supp. 1998); CAL. CORP. CODE § 17301 (West Supp. 1999); DEL. CODE ANN. tit. 6, § 18-702 (1993 & Supp. 1998).

214. As early as 1993 businesses were catching on to the LLC as a flexible form of business. See John R. Emshwiller, *New Kind of Company Attracts Many—Some Legal, Some Not*, WALL STREET J., Nov. 8, 1993 at B1. Since then, LLC have increased in popularity. In California, LLC filings have consistently risen since California passed its LLC Act in 1994. In 1994, 977 LLCs were created; in 1995, 7,396; in 1996, 12,151; in 1997, 17,932; and in 1998 (as of January 31), 2,029. See Telephone Interview with California Secretary of State (February 17, 1998) (on file with author). In Delaware, the total number of LLCs in existence rose from 21,619 to 42,266 in 1997. See Telephone Interview with Delaware Secretary of State (February 20, 1998) (on file with author).

215. See Michael Hampton Boles & Susan Pace Hamill, *Agency Powers and Fiduciary Duties Under the Alabama Limited Liability Company Act: Suggestions for Future Reform*, 48 ALA. L. REV. 143, 145-6 (1996) [hereinafter Boles & Hamill]; RIBSTEIN & KEATINGE ON LLCs, *supra* note 182, §§ 9.01-9.11.

216. Unless Congress names LLC interests in Section 2(1) of the Securities Act of 1933, the definition of "investment contract" will determine whether an LLC interest is a security. See 15 U.S.C. § 77(b)(1) (1994). In *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court pronounced a four-part test for "investment contracts":

[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

W. J. Howey Co., 328 U.S. at 298-99.

Several commentators have argued that an LLC interest is a security interest. See John A. Peralta, *Limited Liability Company Interests as Securities*, 1 ENFORCEMENT L. REP. 29, 36 (1993); Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105 (1992). For others that have argued that an LLC is presumptively not a security see Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage this*

and a general lack of case law and experience with the LLC present valid concerns to the practitioner who does not want to make his client a test case.²¹⁷ Further, in states like Texas, LLC's are subject to state franchise taxes.²¹⁸ Nevertheless, many business organizers have found the LLC desirable and are willing to take on some risk in return for the LLC's flexibility and favorable taxation.²¹⁹

III. THE THREE-STATUTE MODEL

The general partnership, limited partnership, LLP, and close corporations each have considerable problems. Federal taxation is often the cause of these problems. However, federal taxation should no longer dictate business formation decisions because the check-the-box regulations allow total flexibility. These regulations enable each state's law makers to simplify business enterprises statutes.²²⁰ Hence, states can cater more

Result, 45 HASTINGS L.J. 1223 (1994); Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994) [hereinafter Ribstein, *Form and Substance*]; MARK A. SARGENT, LIMITED LIABILITY COMPANY HANDBOOK, ch. 3 (1993-94); Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069 (1992). Still others have argued for a case-by-case approach, see Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part II)*, 37 SAN DIEGO L. REV. 467, 510-18 (1992); Elaine A. Welle, *Limited Liability Company Interests as Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws*, 73 DENV. U. L. REV. 425 (1996).

State statutes could help resolve some of this debate. For example, California creates the presumption that an LLC interest is a security:

"Security" means any . . . membership in an incorporated or unincorporated association; . . . interest in a limited liability company and any class or series of such interests (including any fractional or other interest in such interest), except a membership interest in a limited liability company in which the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company; provided that evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company . . .

CAL. CORP. CODE § 25019 (West Supp. 1998).

217. See *Check-the-Box and Beyond*, *supra* note 6, at 618 ([William R. Asbell] suggesting that practicing lawyers "tend to recommend those things that have a body of established law behind them."); Oesterle & Gazur, *supra* note 6, at 121. Also, third parties may be slow to do business with LLCs. Creditors, for instance, may hesitate because of unclear agency laws in the LLC. See Gerald J. Kehoe et al., *Lending to Limited Liability Companies*, 10 COM. LENDING REV. 4, 4-13 (1995). LLCs will bear the cost from third parties' hesitancy to do business with the LLC. See Ribstein, *Emergence of the LLC*, *supra* note 161, at 12.

218. See TEX. TAX CODE ANN. § 171.001(a)(1), (b)(2) (West 1992); see generally Erickson & Sanders, *supra* note 60, at 1006; Kathryn A. Pischak, *State Issues Complicate the Decision to Do Business as a Limited Liability Company*, 83 J. TAX'N 76, 76-79 (1995).

The franchise tax rates are the greater of 25% of net taxable capital or 4.5% of net taxable earned surplus. See TEX. TAX CODE ANN. § 171.002 (West 1992).

219. See *supra* notes 8 and 214.

220. Several commentators have suggested states use the check-the-box regulations as a catalyst to create a more simplified business enterprises statutory scheme. See *Check-the-Box and Beyond*, *supra* note 6, (discussing various options for the future of state corporate and limited liability codes); Loewenstein, *supra* note 20 (proposing a two-statute approach:

closely to the needs of business associations, investors, and the general public.

This proposal suggests that state legislatures and bar organizations focus on three forms of organization. First, the general partnership should remain an ideal form for informal ventures where the parties have failed to make a state filing.²²¹ Second, the traditional corporation serves publicly traded companies well by providing predictability and consistency from state-to-state.²²² Third, the LLC's contractarian nature can be expanded to meet the needs of the close corporation, limited partnership, LLP, and other miscellaneous business forms. Aside from a few mandatory rules, the LLC should remain a highly flexible, contractarian business form with protective default rules that can be altered in the operating agreement.

This section discusses changes that should be made to each of the these three forms. Both corporations and partnerships have a well-developed body of law and need few changes. The LLC, however, is still developing. Thus, the discussion that follows gives little emphasis to corporations and general partnerships, but much attention is given to LLCs.

A. CORPORATIONS

For most of its history, the corporation has been replete with rules like duty of loyalty and dissenters' rights, which may not be altered by agreement.²²³ Recently, mandatory rules have been challenged, both theoretically and practically, by those who argue that corporate statutes should take a contractarian focus.²²⁴ Proponents of more enabling corporate statutes suggest that the corporation is merely a "nexus of contracts."²²⁵ They argue that corporation statutes should provide a set of "off-the-rack" terms that the parties could contract around, instead of mandatory rules.²²⁶

Opponents of the contractarian approach (the "anti-contractarians") argue for mandatory rules to ensure shareholders are adequately pro-

the traditional corporation with mandatory provisions and a limited liability entity that is largely contractarian in approach); Oesterle & Gazur, *supra* note 6, at 102-03 (proposing a three-prong approach to small business statutes: (1) "limited liability partnerships;" (2) "close companies;" and (3) "private corporations"). Other commentators have used the check-the-box regulations to recommend changes that should take place in specific LLC statutes. See Susan Kalinka, *The Limited Liability Company Law After "Check-the-Box,"* 57 LA. L. REV. 715 (1997) (suggesting reform of Louisiana's LLC statute); Powers & Forry, *supra* note 63 (evaluating the Wyoming LLC and making suggestions for the future).

221. See Oesterle & Gazur, *supra* note 6, at 116-18.

222. See Loewenstein, *supra* note 20, at 456.

223. See Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1396-99 (1989).

224. See *id.*; Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989) [hereinafter Easterbrook & Fischel].

225. *Id.* at 1426-28; Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449 (1989).

226. See Easterbrook & Fischel, *supra* note 224, 1444-46.

tected.²²⁷ They say that “bargaining among the shareholders, or between managers and the shareholders as a body, is virtually impossible. Accordingly, most of the constitutive rules of such corporations are determined not by contract, but by law”²²⁸ But contractarians insist that such mandatory rules impede the corporation’s ability to remain flexible and thereby competitive.²²⁹

Professor Mark J. Loewenstein is critical of extremists in both camps.²³⁰ He has suggested that mandatory provisions in corporate codes should remain intact, while the “contractarian viewpoint ought to find its expression in alternatives to incorporation.”²³¹ Thus, corporate statutes should retain a core set of mandatory rules. Minority protections like dissenters’ rights and the duties of loyalty and care are good examples of what should be mandatory in the corporate form.²³² Directors and shareholders should not be able to waive these protections by agreement. This way, the investing public will continue to know what to expect when they buy stock in a corporation and how they will be protected if things go wrong.²³³ Furthermore, if states make the LLC desirable to closely held corporations, they can distinctly focus on the needs of publicly held companies privately held companies separately. Such focus will stop the “spillover” effect that has occurred over the last several years.²³⁴

The three-statute approach in this proposal contemplates Professor Loewenstein’s view of the corporation.²³⁵ As the LLC replaces the close corporation,²³⁶ states will find it easier to focus on the needs of large and publicly held corporations, and their shareholders, when amending its corporation law.

B. GENERAL PARTNERSHIPS

Among the three proposed entities, unlimited liability of partners will frequently make the general partnership the most undesirable. But there is a segment of the public that will engage in business without considering

227. See generally Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1471-1515 (1989) (arguing for mandatory rules).

228. See *id.*

229. See Easterbrook & Fischel, *supra* note 224, at 1427-28 (“The structure suited to a dynamic, growing firm such as Xerox in 1965 is quite unsuited to Exxon in 1965 (or to Xerox in 1989).”).

230. See Loewenstein, *supra* note 20, at 465-66.

231. *Id.* at 471.

232. See *id.*

233. See generally 1 PAINTER ON CLOSE CORPORATIONS, *supra* note 150, §§ 1.4, 3.1.2.

234. See Ian Ayers, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U.L.Q. 365, 395 n.124 (1992).

235. Professor Loewenstein’s argument is consistent with this proposal to the extent that the corporation should have mandatory rules. But his approach is not adopted here to the extent that he proposes total waiver of fiduciary duties in the LLC. See Loewenstein, *supra* note 20, at 471.

236. Professor Ribstein has speculated that “the LLC phenomenon could spell the end of the close corporation business form.” Ribstein, *Theories and Evidence from LLCs*, *supra* note 10, at 431. This proposal not only suggests that the close corporation *could* be replaced by the LLC but that as a practical matter it *should* be.

forming an entity under state law.²³⁷ The broad language of the Uniform Partnership Act only requires (1) two or more people with (2) intent to associate (3) to carry on a business (4) for a profit.²³⁸ As such, the general partnership should continue to function as a catch-all form of business association for those who choose not to file with the state.²³⁹

This form is necessary to protect third parties that do business with the informal partnership. For example, under general partnership law, a third-party creditor can hold both partners liable for a recourse loan to the partnership.²⁴⁰ This form is also necessary to protect the general partners themselves. Well-established case law gives general partners a rightful expectation that their co-partners will have “the punctilio of an honor most sensitive” as a standard guiding their conduct.²⁴¹ Thus, general partnership law is still necessary to protect these (and other) interests.

C. A VISION FOR LLC STATUTES

In order for this simplified structure to work, LLCs must be designed to cater to all business organizations that are not corporations or general partnerships (e.g., limited partnership, LLP, LLLP, close corporation). Thus, the LLC must remain highly flexible.

The focus and purpose of the LLC has been to create a flexible statute that allows parties to form a customized business entity. Thus far, the primary constraint upon LLC statutes and operating agreements has been federal taxation. Now that the LLC can be developed whichever way the state would like, the inclination may be to create a “blank screen” approach. That is, the state offers an entity the ability to get limited liability with few, if any, restrictions. Many times, however, this approach will cut too much into a state’s ability to protect the public. This Section suggests that the preferred approach is to adopt default rules that can be easily changed in an LLC’s operating agreement.

1. The “Default Rule” Approach

Professor Ribstein has argued that default rules are unnecessary since rational actors “take into account the fact that they are not well informed and knowledgeable.”²⁴² He would design an LLC with few default rules

237. See Oesterle & Gazur, *supra* note 6, at 117.

238. See UPA *supra* note 97, § 6; see also *supra* note 75.

239. See Oesterle & Gazur, *supra* note 6, at 117.

240. See, e.g., *Minute Made Corp. v. United Foods*, 291 F.2d 577 (N.Y. 5th Cir.), *cert. denied*, 368 U.S. 928 (1961). Cf. *Martin v. Peyton*, 158 N.E. 77 (1927). See generally BROMBERG & RIBSTEIN ON PARTNERSHIP, *supra* note 100, § 2.14.

241. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928); see also *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 515-16 (Mass. 1975). See, e.g., *Gaines v. Hamman*, 358 S.W.2d 557, 560-61 (Tex. 1962).

242. Robert W. Hamilton & Larry E. Ribstein, *The Future of the Unincorporated Firm, Limited Liability and the Real World*, 54 WASH. & LEE L. REV. 687, 692 (1997) [hereinafter Hamilton & Ribstein].

since rational actors will become informed and make decisions accordingly.

But this proposal argues for the adoption of a comprehensive set of default rules. A flexible LLC statute is preferable, and maybe even essential, for a state to be competitive with other states.²⁴³ Thus, instead of the “blank screen” approach, states should prefer a statute with several default rules that will protect members who are in the minority and parties that choose not to use legal counsel when forming an LLC.²⁴⁴

While LLC statutes should have default rules, it is not because the state should favor parties who proceed without consulting a competent lawyer. Nor should states impose cumbersome rules on sophisticated parties. Rather, under the LLC formation theory, as proposed here, the relative cost of default rules to a sophisticated businessperson is low—they may simply write an operating agreement that changes the default rule. The cost savings, however, to the unsophisticated business person could be quite high.²⁴⁵

Thus, in order to keep the LLC form flexible, each default rule should be preceded by “unless otherwise agreed” language, or the entire LLC statute should be preceded with a general provision that the operating agreement governs the LLC with few exceptions.²⁴⁶ This would allow the parties to contract around any default rule in the statute.

Under this approach, a less sophisticated party will either receive protection by default or will learn of the protection if the more sophisticated party tries to put it in the operating agreement. Theoretically, the agreement that ensues will more closely match the bargaining power of the parties, instead of their relative legal sophistication.

243. See Powers & Forry, *supra* note 63, at 849-53 (calling for the Wyoming legislature to act quickly and amend the LLC to create a more flexible entity, which would attract companies to Wyoming and increase “revenue and notoriety for the State”).

244. For a discussion on the value of protecting the unsophisticated public by default rules, see Hamilton & Ribstein, *supra* note 242, at 690.

245. See Ribstein, *Emergence of the LLC*, *supra* note 161, at 2-3.

246. The Uniform Limited Liability Company Act has such a general provision. It reads as follows:

(a) Except as otherwise provided in subsection (b), all members of a limited liability company may enter into an operating agreement, which need not be in writing, to regulate the affairs of the company and the conduct of its business, and to govern relations among the members, managers, and company. To the extent the operating does not otherwise provide, this [Act] governs relations among the members, managers, and company.

(b) The operating agreement may not:

...

- (2) eliminate the duty of loyalty . . .
- (3) unreasonably reduce the duty of care . . .
- (4) eliminate the obligation of good faith and fair dealing . . .
- (5) vary the right to expel a member [because of wrongful conduct];

...

- (7) restrict [the] rights of a person, other than a manager, member, and transferee of a members' distributional interest, under this [Act].

UNIF. LTD. LIAB. CO. ACT § 103 (1995), 6A U.L.A. 425 (1995) [hereinafter ULLCA].

This proposal argues for the inclusion of four statutory default rules: restricted transferability of interest, member management, continuity of life, and minority protections. Next, mandatory rules are discussed: fiduciary duties and agency restrictions. Last, there is a discussion on when liability should be imposed on LLC members and a suggestion that states add statutory language on piercing the corporate veil.

2. *Default Rule: Restricted Transferability of Interest*

One of the undesirable effects of incorporation for close corporations is free transferability of corporate stock.²⁴⁷ Restrictions on transferability are often desirable in closely held firms due to the close connection between ownership and management.²⁴⁸ Indeed, the LLC was tailored to the needs of closely held business association.²⁴⁹ Thus, LLC statutes should retain a default rule that restricts transferability barring unanimous²⁵⁰ or majority-in-interest²⁵¹ consent. This rule is an improvement on the close corporation where transferability cannot be fully restricted,²⁵² and it still allows the LLC members to contract for transferability.

But restrictions on transferability have been criticized, even before the check-the-box regulations were announced.²⁵³ It has been argued that such restrictions are unnecessary because LLC members have limited liability; therefore, "the transfer of management rights in an LLC is not the sort of momentous event that it may be in a general partnership."²⁵⁴ This argument is flawed since close corporations, which have limited liability, encountered the need to restrict transferability; the need for restriction has not changed with the LLC.²⁵⁵ Also, a default rule ensures that parties will not have a stranger forced upon them without specifically having bargained for transferability in the operating agreement or without having specifically approved the admittance of a new member.²⁵⁶

This rule would require the approval of a majority-in-interest of the members to transfer.²⁵⁷ But parties to a transaction can then contract for varying degrees of transferability. For example, some parties may choose

247. Shareholders in a close corporation are "quite unwilling to accept the free transferability of corporate state whereby strangers by be foisted upon them." ROHRLICH, *supra* note 90, § 2A.04.

248. See ROHRLICH, *supra* note 90, § 2A.04.

249. See Keatinge et al., *A Study of the Emerging Entity*, *supra* note 56, at 378-81.

250. See, e.g., ALA. CODE. § 10-12-31(a)(1) (1994); ALASKA STAT. § 10.50.165(a) (Michie 1998); LA. REV. STAT. ANN. § 12:1332(a)(1) (West 1994).

251. See, e.g., CAL. CORP. CODE § 17303(a) (West Supp. 1999); FLA. STAT. ANN. § 608.432(1)(a) (West Supp. 1999); N.Y. LTD. LIAB. CO. LAW § 604(a) (McKinney 1999).

252. See *supra* notes 146-53.

253. See Ribstein, *Emergence of the LLC*, *supra* note 161, at 5-6, 14-15.

254. See *id.* at 15.

255. See O'NEAL'S CLOSE CORPORATIONS, *supra* note 137, § 1.14; ROHRLICH, *supra* note 90, § 2A.04.

256. See ROHRLICH, *supra* note 90, § 2A.03.

257. See, e.g., CAL. CORP. CODE § 17303(a) (West Supp. 1998); FLA. STAT. ANN. § 608.432 (West Supp. 1999); N.Y. LTD. LIAB. CO. LAW § 604 (McKinney 1999).

to contract for right of first refusal²⁵⁸ or may put a buy-sell agreement in the operating agreement.²⁵⁹ Others, however, may opt for a more restrictive provision that requires unanimous consent or the corporate standard of complete transferability (*i.e.*, no consent).²⁶⁰

3. *Default Rule: Member Management*

Another vestige of the *Kintner* classification rules is member management.²⁶¹ Most states have a default rule that requires the LLC be managed by its members.²⁶² LLCs are then permitted to elect manager management as long as it is in the operating agreement²⁶³ or articles of organization.²⁶⁴ A member-managed LLC is analogous to the general partnership, and a manager-managed LLC is analogous to a limited partnership or corporation.²⁶⁵

The check-the-box regulations allow states to structure the LLC even more like a corporation by making the default rule manager-management. Closely-held firms, however, generally prefer some form of member management, and large firms can easily contract around this default rule. Thus, since the default rules in this proposal are designed to protect parties that will not seek legal counsel prior to forming an LLC, it would be ill-advised for states to change the member-management default rule. Moreover, those states that do not have such a default rule should amend their statutes to provide for the member-management default.²⁶⁶

Similarly, the ability of LLCs to change their management structure is beneficial. While limited liability and favorable taxation have been fun-

258. See *Sorlie v. Ness*, 323 N.W.2d 841, 846 (N.D. 1982).

259. See *Hodges v. Pittman*, 384 So. 2d 14, 16 (Ala. 1980).

260. Parties to an LLC that plan on perfecting exemptions under the Securities Act of 1933 (the "1933 Act") should be cautious that free transferability does not interfere with those exemptions. For example, certain exemptions under Regulation D require that interests be restricted. See 17 C.F.R. §§ 230.502(d), 230.505, 230.506 (1999). Additionally, resale restrictions are a material fact; therefore, they should be disclosed to comply with the anti-fraud provisions of the 1933 Act and the Securities Exchange Act of 1934 (the "1934 Act"). See 1 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 4.2 (1997). Hence, the issuers should follow the guidelines set forth in Rule 502(d): (1) make a reasonable inquiry as to whether the purchaser is purchasing for his own purpose; (2) make a written disclosure that the securities are not registered pursuant to the Securities Act of 1933, and that the securities may not be resold; and (3) clearly mark on the certificate or other document memorializing the sale of the securities that the securities are not registered pursuant to the Securities Act of 1933, and that the securities may not be resold. See 17 C.F.R. § 230.502(d) (1999).

261. See *supra* note 59.

262. See, e.g., CAL. CORP. CODE § 17150 (West Supp. 1999); TENN. CODE ANN. § 48-238-101 (1995). But see MINN. STAT. ANN. § 322B.606 (West 1995); N.D. CENT. CODE § 10-32-69 (1995); TEX. REV. CIV. STAT. ANN. art. 1528n, 2.12(A) (West 1997).

263. See, e.g., DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1996); GA. CODE ANN. §§ 14-11-301, -304 (Harrison 1998).

264. See CAL. CORP. CODE §§ 17150 -51 (West Supp. 1998). See generally Ribstein, *Emergence of the LLC*, *supra* note 161, at 9-12.

265. See WHITMIRE, *supra* note 63, § 1.05(1) (suggesting LLCs look more like a limited partnership when the managers must be members, but more like a corporation when managers do not need to be owners).

266. See *supra* note 262.

damental to the LLCs existence and growth, flexibility in the management structure has also been instrumental in the LLC's popularity.²⁶⁷ As such, member management should only be a default rule so that LLCs can change their management structures in the operating agreement or articles of organization.

4. *Default Rule: Continuity of Life*

Most LLC statutes provide that the LLC does not have continuity of life.²⁶⁸ All states require dissolution if there is (1) written consent from all members, (2) the happening of a contingency specified in the articles of organization or operating agreement, or (3) a judicial dissolution.²⁶⁹ Most LLC statutes also require that, unless altered by agreement, an LLC dissolves with the disassociation of a member or upon the happening of a triggering event (e.g., death, retirement, resignation, expulsion, bankruptcy, or dissolution of any member).²⁷⁰ Others have no such default rule.²⁷¹ Generally, if the LLC is dissolved, it can continue the enterprise with consent of the members.²⁷² Also, states allow LLCs to contract around continuity of life.²⁷³ Several states, however, have begun repealing their statutes requiring dissolution upon the happening of a trigger event.²⁷⁴

Professor Susan Pace Hamill has argued that states should incorporate the RUPA's disassociation into the LLC and repeal the dissolution

267. See Ribstein, *Emergence of the LLC*, *supra* note 161, at 2. Professor Ribstein states: "The LLC is best understood in terms of four general characteristics: (i) limited liability; (ii) partnership tax features; (iii) *chameleon management*—that is, the ability to choose between centralized and direct member-management; and (iv) creditor-protection provisions." *Id.* (emphasis added).

268. See, e.g., TEX. REV. CIV. STAT. ANN. art. 1528n, 2.12 (West 1997); N.Y. LTD. LIAB. CO. LAW § 701 (McKinney Supp. 1999); TENN. CODE ANN. § 48-245-101 (1995).

269. See, e.g., ALASKA STAT. § 10.50.400 (Michie 1994); CAL. CORP. CODE § 17350 (West 1998); N.Y. LTD. LIAB. CO. LAW § 701 (McKinney Supp. 1999).

270. See, e.g., CAL. CORP. CODE § 17350 (West 1998) (requiring dissolution if one of the foregoing happens to a member of a member-managed LLC, but only to a manager of a manager-managed LLC); DEL. CODE ANN. tit. 6, § 18-801 (Supp. 1996); N.Y. LTD. LIAB. CO. LAW § 701 (McKinney Supp. 1999).

271. See, e.g., ALASKA STAT. § 10.50.400 (Michie 1998); ARK. CODE ANN. § 4-32-901 (Michie Supp. 1998).

272. States differ in their approach regarding the number of members required to consent to the continuation of the enterprise. For instance, some LLC statutes require unanimous consent of the remaining members following the disassociation of a member. See, e.g., ALASKA STAT. § 10.50.400 (Michie 1998). Others require consent of only the majority-in-interest. See, e.g., CAL. CORP. CODE § 17350 (West Supp. 1998); NEB. REV. STAT. § 21-2621 (Supp. 1996); N.Y. LTD. LIAB. CO. LAW § 701 (McKinney Supp. 1999). But most provide that this is just a default rule, which can be circumvented by a provision in the operating agreement or both the articles of organization and the operating agreement. See, e.g., ALASKA STAT. § 10.50.400 (Michie 1998); CAL. CORP. CODE § 17350 (West Supp. 1998); N.Y. LTD. LIAB. CO. LAW § 701 (McKinney Supp. 1999); NEB. REV. STAT. § 21-2621 (1997).

273. While some states still require dissolution upon the traditional triggering events, this is only a default rule and can be changed in the operating agreement or the articles of incorporation.

274. See, e.g., COLO. REV. STAT. ANN. § 7-80-801 (West 1999).

rules.²⁷⁵ She traced the rules in the general partnership and the close corporation to analyze their competing policy considerations. Under the Uniform Partnership Act (UPA), a dissenting partner may withdraw, and the partner's withdrawal causes dissolution of the partnership.²⁷⁶ The withdrawing partner's interest can be bought out by the remaining partners or the assets of the partnership can be sold at a judicial sale.²⁷⁷ The individual partners could wind up the partnership, or agree to continue the venture in a succeeding partnership.²⁷⁸ Thus, a dissenter with legitimate complaints about the partnership can withdraw, but if the dissenter wrongfully withdraws he will be liable for damages.²⁷⁹

The RUPA, by contrast, does not require that a partnership dissolve upon a partner's "disassociation."²⁸⁰ In fact, the remaining partners have ninety days to agree to wind up or dissolve the partnership, or the partnership will continue.²⁸¹ The RUPA values the withdrawing partner's interest "based on 'the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the disassociated partner' that 'would be paid by a willing buyer to a willing seller.'"²⁸² But in an at-will partnership, as in the UPA, a partner's disassociation still causes the dissolution of the partnership.²⁸³

On the other hand, close corporation statutes strongly favor continuity of life, but there is generally no ready market for stock in close corporations.²⁸⁴ Hence, statutory and judicial solutions surfaced to protect minority shareholders from oppression.²⁸⁵ But Professor Hamill argues that these solutions are insufficient compared to the relative ease with which a partner may withdraw from a partnership.²⁸⁶ Thus, an LLC member's withdrawal should trigger a buyout of the member's interest but not cause the dissolution of the partnership, regardless of the reason for withdrawal.²⁸⁷

This proposal argues for the repeal of dissolution and disassociation rules for several reasons. First, perpetual life is probably the option that most LLC organizers would choose.²⁸⁸ One aim of default rules is to anticipate what most parties would choose. Absent a compelling compet-

275. See Farrar & Hamill, *supra* note 15, at 922-23, 938-39.

276. See UPA, *supra* note 97, § 31; 2 BROMBERG & RIBSTEIN ON PARTNERSHIP, *supra* note 100, § 7.01(a).

277. See UPA, *supra* note 97, §§ 29, 31, 38; 2 BROMBERG & RIBSTEIN ON PARTNERSHIP, *supra* note 100, § 7.13.

278. See 2 BROMBERG & RIBSTEIN ON PARTNERSHIP, *supra* note 100, § 7.01.

279. A partner who wrongfully withdraws is entitled to the value of his partnership interest less any damages. See *id.* § 7.13(b)(1).

280. *Id.* § 7.13(a).

281. See *id.*

282. *Id.*; see also RUPA, *supra* note 97, § 701(a).

283. See RUPA, *supra* note 97, § 801; see also Farrar & Hamill, *supra* note 15, at 919-20.

284. See Farrar & Hamill, *supra* note 15, at 924.

285. See 2 O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS, *supra* note 83, §§ 7.11-7.14.

286. See Farrar & Hamill, *supra* note 15, at 939.

287. See *id.* at 938-39.

288. See Oesterle & Gazur, *supra* note 6, at 144.

ing policy this is a reasonable basis to select a default rule.²⁸⁹ Second, the state has an economic interest in keeping capital in businesses. In other words, default rules should be weighted toward continuing the venture. Close corporation minority protection rules generally accomplish this result by allowing dissolution only when the success of the enterprise is at stake.

Third, if the rule is not repealed, there could be unfavorable taxation treatment to family limited partnerships that want to convert to an LLC.²⁹⁰ The Code's Chapter 14 valuation rules could significantly deter families from organizing under LLC statutes instead of limited partnership statutes.²⁹¹ Like the family limited partnership, family LLCs are designed to gift LLC interests to family members in lower tax brackets. Also, when the parent dies, the LLC interests are left in the estate. The tax advantage of a family LLC—and family limited partnership—comes with the reduced valuation of the LLC interests as opposed to the property in the LLC.²⁹² But Code section 2704 denies discounts on valuations of all interests except where state or federal law provides a restriction (i.e., continuity of life).²⁹³ Professor Hamill argues that this is not a sufficient reason to repeal the dissolution rules. She characterizes the family limited partnership as an “effective tool for gift and estate tax planning.”²⁹⁴ But the family partnership is more than a tax tool. Families with businesses—generally small businesses—should have a form that permits them to transfer the family business from one generation to the next without onerous tax consequences. Furthermore, these families should not be relegated to the limited partnership, which requires a general partner to assume liability.

Thus, for the foregoing reasons, the LLC's dissolution rules should be repealed. But, absent rules regarding minority oppression, this may leave no appropriate method for resolving disputes among members. As such, minority oppression default rules must accompany the repeal of the LLC's dissolution rules.

5. *Default Rule: Protection of Minority Members from Oppression*

An LLC with an operating agreement containing provisions that centralize management, restrict transferability of LLC interests, and provide perpetual life may present considerable problems for a minority member.

289. See CHARLES R. O'KELLEY, JR. & ROBERT B. THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS* 47-51 (2d ed. 1996).

290. See *supra* text accompanying notes 122-30.

291. See Ribstein, *New Choice of Entity*, *supra* note 164, at 338-40. But Chapter 14 may not require states to remove the dissolution rules. The family LLC may be valued favorably even if the dissolution rules remain. See Jerry A. Kasner, *Does Check-the-Box Spell Doom for Family Limited Partnerships?*, 74 *TAX NOTES* 474, 475 (1997); Jerry A. Kasner, *LLCs as Family Business Entities—Not There Yet, But Getting Closer*, 67 *TAX NOTES* 1357, 1357 (1995).

292. See *supra* text accompanying notes 122-30.

293. See Oesterle & Gazur, *supra* note 6, at 132-41.

294. Farrar & Hamill, *supra* note 15, at 934 n.107.

If there is oppressive conduct on the part of majority members, the minority member may not be able to adequately protect himself. In other words, the minority member will not be able to withdraw and cause dissolution—as in the UPA or RUPA—nor would he be able to sell his interest to a third party since the LLC has transfer restrictions (also, minority LLC interests are generally illiquid).²⁹⁵ Additionally, since this is a manager-managed LLC, the member may not be able to influence the management of the business in any significant way. Thus, minority protections, much like those in a statutory close corporation, should be added to LLC statutes.

The legal evolution of close corporation statutes produced several attempts at controlling minority oppression in the corporation. Several states allow for judicial dissolution in the event that there is a deadlock on the board of directors.²⁹⁶ Other states have developed more aggressive statutes. For example, judicial dissolution is permitted in several states if “[t]he directors or those in control of the corporation have acted, are acting, or will act in a manner that is *illegal, oppressive, fraudulent, or unfairly prejudicial*”²⁹⁷ Alaska and California go even further: dissolution is appropriate anytime “liquidation is *reasonably necessary* for the protections of the rights or interests of the complaining shareholder”²⁹⁸

In order to adequately protect minority members in an LLC from oppression, states should incorporate default rules that give courts some discretion when trying to protect minority members. Thus, LLC statutes should at least provide for dissolution any time control members are acting in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial.²⁹⁹ Better yet, LLC statutes could provide for dissolution any time it is “reasonably necessary” to a minority member’s rights.³⁰⁰

295. See *id.* at 924.

296. See, e.g., COLO. REV. STAT. ANN. §§ 7-114-301, -302 (West 1999); GA. CODE ANN. § 14-2-940(a)(2) (Harrison 1998); OHIO REV. CODE ANN. § 1701.91(a)(4) (Anderson 1997); see also 2 O’NEAL’S OPPRESSION OF MINORITY SHAREHOLDERS, *supra* note 83, § 7.11.

297. GA. CODE ANN. § 14-2-940(a)(1) (Harrison 1998) (emphasis added); see also COLO. REV. STAT. ANN. § 7-114-301(2)(b) (West Supp. 1999); MD. CODE ANN., CORPS. & ASS’NS § 3-413(b)(2) (Supp. 1998); O’NEAL’S OPPRESSION OF MINORITY SHAREHOLDERS, *supra* note 83, §§ 7.12, 7.13.

298. CAL. CORP. CODE § 1800(b)(5) (West Supp. 1998) (emphasis added); ALASKA STAT. § 10.06.628(b)(5) (Michie 1996); see 2 O’NEAL’S OPPRESSION OF MINORITY SHAREHOLDERS, *supra* note 83, § 7.14. California and Alaska also allow dissolution where “[t]hose in control . . . have been guilty of or have knowingly countenanced persistent and pervasive fraud, mismanagement or abuse of authority or persistent unfairness toward any shareholders or its property is being misapplied or wasted by its directors or officers.” CAL. CORP. CODE § 1800(b)(4) (West Supp. 1998); see ALASKA STAT. § 10.06.628(4) (Michie 1996).

299. See, e.g., GEORGIA § 14-2-940(1) (Harrison 1998); see also COLO. REV. STAT. ANN. § 7-114-301(2)(b) (West 1999); MD. CODE ANN., CORPS. & ASS’NS § 3-413(b)(2) (Supp. 1997).

300. See, e.g., CAL. CORP. CODE § 1800(b)(5) (West Supp. 1998); ALASKA STAT. § 10.06.628(5) (Michie 1998).

Additionally, instead of only providing for judicial dissolution, states should consider expanding remedies available to dissenting LLC members. The Illinois corporations statute has such alternative remedies, which include appointing a provisional director, appointing a custodian, and ordering a purchase of the complaining shareholder's shares.³⁰¹ LLC statutes should provide these options, which would allow judges to give an appropriate remedy to minority members without always having to dissolve the enterprise.

6. *Mandatory Rule: Fiduciary Duty*

While many states define, to some degree, fiduciary duties in the LLC,³⁰² the appropriate analogy to other business forms has not been determined by the courts.³⁰³ State statutes could assist the courts in determining the correct analogy and giving the courts direction in how extensive a waiver of fiduciary duty should be allowed.

First is the question of the appropriate analogy. State statutes should determine the analogy for the courts to reduce the uncertainty that accompanies the LLC form.³⁰⁴ Since the LLC, according to this proposal, will be replacing the close corporation, limited partnership, and LLP—all of which have partnership-like fiduciary duties—states should adopt the analogy of the partnership.³⁰⁵ In other words, legislatures should direct courts with express language in the LLC statute to apply the same fiduciary standard owed by a partner to a partnership.³⁰⁶ This rule should apply in manager-managed as well as member-managed LLCs.³⁰⁷

Second, whether the parties to an LLC should be allowed to waive their fiduciary duties is a question that should be considered carefully.

301. See 805 ILL. COMP. STAT. ANN. 5/12.55 (West 1993 & Supp. 1999).

302. See, e.g., KAN. STAT. ANN. §§ 17-7613, 17-7647 (1995 & Supp. 1998); VA. CODE ANN. §§ 13.1-1024 to 1028 (Michie 1993 & Supp. 1998).

303. See RIBSTEIN & KEATINGE ON LLCs, *supra* note 182, § 9.01.

304. See generally Boles & Hamill, *supra* note 215, at 160-71 (arguing that fiduciary duties should be added to the Alabama LLC statute); Keatinge et al., *A Study of the Emerging Entity*, *supra* note 56.

305. As then Chief Justice Cordozo suggests, a partner's duty to fellow partners is one of the highest duties imposed by law:

Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928); see also *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 515-16 (Mass. 1975) (holding the *Meinhard* standard also applies to shareholders of a close corporation).

306. California has such a statute: "The fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership." CAL. CORP. CODE § 17153 (West Supp. 1998).

307. See Boles & Hamill, *supra* note 215, at 162-71.

There are economic advantages to allowing an LLC to waive fiduciary duties.³⁰⁸ Mandatory provisions may not suit all firms well.³⁰⁹ For example, some firms may authorize managers to conduct business outside the firm as a form of compensation.³¹⁰ Also, firms may want to cut costs avoiding time-consuming litigation on breaches of fiduciary duty.³¹¹

Several commentators find these arguments persuasive and have argued that states should adopt a total waiver provision.³¹² They argue that parties should be able to waive all duties, except the contractual duty of good faith.³¹³ “[P]arties should be able to alter their default duties in their agreements as long as they are held to good faith compliance with their contracts.”³¹⁴

But the relative economic benefits associated with allowing waiver of fiduciary duties should be offset by the potential cost. First, “the parties and their counsel may be sufficiently unsophisticated that informed consent is illusory.”³¹⁵ Second, parties may not be able to effectively foresee potential wrongdoing.³¹⁶ Third, in an LLC where interests are freely transferable and withdrawal of a member does not cause dissolution, members may not be able to properly defend themselves by selling their

308. See RIBSTEIN & KEATINGE ON LLCs, *supra* note 182, § 9.04.

309. *See id.*

310. *See id.*

311. *See id.* There are other economic advantages associated with allowing waiver of fiduciary duties:

[1] Fiduciaries have varying costs of foregoing opportunities outside the firm

[2] Firms and insiders have potential scope economies of information . . . acquired in their other dealings . . .

[3] Fiduciary duties arise in relationships in which it is in the beneficiary’s interest to delegate open-ended decisionmaking power to the fiduciary. . .

Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 548-49 (1997) [hereinafter Ribstein, *Fiduciary Duty*]; *see also* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990) [hereinafter Butler & Ribstein].

312. See Ribstein, *Fiduciary Duty*, *supra* note 311, at 548-50; Butler & Ribstein, *supra* note 311.

313. “[T]he function of [the duty of good faith] is to supply terms the parties could not determine in advance; it follows that the parties could not knowingly consent to the scope of any general waiver.” RIBSTEIN & KEATINGE ON LLCs, *supra* note 182, § 9.07; *see also* 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS, §§ 7.17, 7.17a (1990).

314. Ribstein, *Fiduciary Duty*, *supra* note 311, at 594. Delaware also has such a waiver position:

(c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager:

(1) Any such member or manager or other person 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 or other person’s good faith reliance on the provisions of the limited liability company agreement; and

(2) The member’s or manager’s or other person’s duties and liabilities may be expanded or restricted by provisions in a limited liability company agreement.

DEL. CODE ANN. tit. 6, § 18-1101(c) (Supp. 1996).

315. RIBSTEIN & KEATINGE ON LLCs, *supra* note 182, § 9.04.

316. *See id.*

interest or withdrawing from the LLC.³¹⁷

Manager-managed LLCs, however, are more analogous to the corporation or limited partnership than the general partnership.³¹⁸ The partnership standard of fiduciary duties may be too stringent in this context.³¹⁹ Members in a manager-managed LLC may want less strict fiduciary duty rules. They may also want to afford managers the protection of the business judgment rule.³²⁰

Thus, states should either adopt a limited waiver provision³²¹ or not permit waiver at all. Several states and the Model LLC Act have limited waiver provisions.³²² In the Model LLC Act, many fiduciary duties can be waived with the exception of a total elimination of the duty of loyalty and duty of care.³²³ States should be no more permissive than the Model LLC Act.

7. *Mandatory Rule: Agency Restrictions*

Uncertainty about whether a particular member can bind an LLC has caused third parties much concern in dealing with LLCs. Many third parties that do business with LLCs do so warily because the agency authority of members can be expanded or limited in most states with little notice.³²⁴ In many states, LLCs can limit authority by merely putting the restriction in the operating agreement and putting a general statement in the articles of organization that authority has been limited.³²⁵ Other

317. *See id.* §§ 9.10, 9.11 (predicating their position that waiver should be allowed upon the assumption that transfer of interests would be restricted and LLCs would lack continuity of life—this is not so after check-the-box). Even if other minority protections are included in LLC statutes they will be default rules. A default rule on fiduciary duties is one protection that should not be allowed to be waived. For more on the benefits of fiduciary duties, see Ribstein, *Fiduciary Duty*, *supra* note 311, at 546-48.

318. *See* Boles & Hamill, *supra* note 215, at 164-71; Ribstein, *Emergence of the LLC*, *supra* note 161, at 9-12.

319. *See generally* Boles & Hamill, *supra* note 215, at 171.

320. *See generally id.*

321. One commentator has suggested that the prevention of theft, self-dealing, and waste are one of the top three non-tax concerns of a close corporation. *See* Oesterle & Gazur, *supra* note 6, at 130.

322. *See* ULLCA, *supra* note 246, § 103; HAW. REV. STAT. § 428-103 (1997); VT. STAT. ANN. tit. 11, § 3003 (1997).

323. *See* ULLCA, *supra* note 246, § 1.03.

324. Increased investigation costs and uncertainty as to the security of a transaction could cause third parties concern about dealing with LLCs, concerns which will manifest themselves as increased costs to the LLC. *See* Ribstein, *Emergence of the LLC*, *supra* note 162, at 12; *see also* Kehoe, *supra* note 217, at 4-13 (“Where there is no actual authority of the member or manager to sign on behalf of the company, there is no case law at present to protect the lender as there is in certain instances where the borrower is a corporation or partnership.”).

325. For instance, in Louisiana:

Persons dealing with a member, if management is reserved to the members, or manager, if management is vested in one or more managers . . . of the limited liability company shall be deemed to have knowledge of restrictions on the authority of such a member or manager contained in the written operating agreement if the articles of organization of the limited liability company contain a statement that such restrictions exist.

states require no such statement in the articles of organization.³²⁶

With either type of statute there are considerable problems. States that do not require disclosure in the articles of organization put the burden on third parties to protect themselves by reading the LLC's operating agreement. An LLC's operating agreement is typically not publicly available and there may even be several agreements.³²⁷ Putting the burden on a third party is both inefficient and leads to confusion in the business community.

States that require minimal disclosure in the articles of organization still place too much burden on third parties. Knowing that authority has been restricted is only marginally helpful without knowing the identity of the member or the nature of the limitation on the member's authority. Hence, the statutes should contain a default rule providing that all members of an LLC have authority to bind the LLC.³²⁸ And states should require LLCs to put third parties on notice by indicating agency restrictions of specific members in the articles of organization.³²⁹

8. *Statutory Language on Piercing the Veil*

The extent of the piercing the veil doctrine is uncertain in the LLC.³³⁰ As it becomes easier to get limited liability through the LLC form, the courts will certainly impose liability upon LLC members in certain instances.³³¹ One of the ways states can make the law more certain and ensure that the public is protected is by putting specific language in the LLC statute that addresses this concern.

When courts pierce the veil of a corporation, they look primarily for the presence of fraud or illegality. Courts will look to see if the corporation is being operated in such a way that a corporation is just an alter ego of the owner.³³² Courts will also consider piercing the corporate veil if

LA. REV. STAT. ANN. § 12:1317(B) (West 1994); *see also* CAL. CORP. CODE § 17151 (West Supp. 1999). This statute could be read to require the LLC to name the members whose authority is restricted and how it is restricted, but the more plausible interpretation would require only a blanket statement that authority of some members has been restricted. *See* Kalinka, *supra* note 220, at 789-91 (suggesting a Louisiana LLC's articles of organization merely need to state: "The LLC's operating agreement contains certain restrictions on the authority of members [or managers] to bind the LLC.").

326. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 1528n, §§ 2.12, 2.21 (West 1997).

327. *See* Kalinka, *supra* note 220, at 790-92.

328. *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 4A-401(a)(1) (Supp. 1998).

329. *See* Kalinka, *supra* note 220, at 792. For instance, all members in a Maryland LLC have agency authority unless otherwise agreed in the articles of organization. *See* MD. CODE ANN., CORPS. & ASS'NS § 4A-401(a)(1), (3) (Supp. 1998).

330. *See generally* Ribstein, *Emergence of the LLC*, *supra* note 161, at 8-9 (stating that the grounds on which courts will pierce the veil of LLCs is one of the most important open questions regarding LLCs); Eric Fox, Comment, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143 (1994) (stating that the "equitable nature of the veil-piercing doctrine prevents the development of strict rules as to when it should be employed").

331. *See* RIBSTEIN & KEATINGE ON LLCs, *supra* note 182, § 12.03.

332. *See generally* Fox, *supra* note 330 (stating that the degree to which the corporation is controlled by the owner is a significant factor for courts to consider when determining whether to pierce the veil).

there is inadequate capitalization or a failure to follow corporate formalities.³³³ Since the LLC has few formalities, there should rarely be an instance of veil piercing because of a failure to follow formalities or that the LLC was an alter ego. But statutory language should provide that courts should apply corporate veil piercing doctrine in cases of fraud or illegality, and should provide that in extreme cases of undercapitalization the veil can be pierced.³³⁴

D. WHAT SHOULD HAPPEN TO OTHER STATUTES?

The next question is what to do with existing statutory forms like the limited partnership, LLP, LLLP, and the statutory close corporation. If such statutes were repealed two potential problems would arise. First, existing organizations formed under a particular statute must still be governed by that statute. It is impractical to force such organizations to immediately convert to the state's new model. In fact, it may be preferable to attract these organizations by offering the highly desirable alternative of the LLC or corporate form. The state's energy and effort should not be placed on forcing organizations to convert but on making it more desirable and easier for them to do so.

Second, the statutes should not be removed since the Treasury has been known to change its mind. If the Treasury decided that check-the-box was not working or not a good policy, then many of the existing entities may again be useful.³³⁵ Although this is unlikely,³³⁶ states should not throw away developed law because to do so may require the state to reinvent the wheel at the Treasury's beckon.

333. *See id.*

334. A good example comes from Colorado's LLC law. There the law specifically incorporates the corporate veil piercing doctrine in the LLC. The statute reads as follows:

(1) In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced

(2) For purposes of this section, the failure of a limited liability company to observe the formalities or requirements relating to the management of its business and affairs is not in itself a ground for imposing personal liability on the members for liabilities of the limited liability company.

COLO. REV. STAT. ANN. § 7-80-107 (West Supp. 1998) (emphasis added).

335. Some commentators have suggested that the Service exceeded its authority by releasing the check-the-box regulations. While a reversal of check-the-box is unlikely, states may need to face regulations like the *Kintner* regulations again. *See* Martin McMahon Jr., *AALS Tax Section Looks at LLCs and Taxation of Business Enterprises*, 70 TAX NOTES 511, 513 (1996); Victor E. Fleischer, "If it Looks Like a Duck": *Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 553, n.165 (1996); Ribstein, *New Choice of Entity*, *supra* note 163, at 345.

336. *See* George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 158-59 (1997).

IV. CONVERSION ISSUES

If a state were to adopt this three-statute approach it would be necessary to promote the system by making it easy for businesses to convert from their existing entity to an entity of choice: the partnership, corporation, or LLC. Conversion from a corporation to an LLC can be prohibitive if state laws do not allow for seamless conversions and if federal or state tax law taxes the transaction. Quick, painless transition will remove the disincentive arising from conversion.

A. UNIVERSAL CONVERSION PROVISIONS

State legislatures should provide universal conversion provisions as either a stand-alone statute or as a sub-part of each of the general partnership, LLC, and corporate statutes.³³⁷ The statute should require the approval of all members in the absence of a contravening agreement between the parties.³³⁸

337. New York and Texas have adopted conversion provisions within their LLC statutes. See N.Y. LTD. LIAB. CO. LAW §§ 1006, 1007 (McKinney Supp. 1999); TEX. REV. CIV. STAT. ANN. art. 1528n, §§ 10.03 to 10.11 (West 1998). Texas has adopted similar provisions in its corporation statute, see TEX. CORPS. & ASS'NS CODE ANN. § 5.17 (West 1997), limited partnership statute, see TEX. REV. CIV. STAT. ANN. art. 6132b, § 9.05 (West Supp. 1998), and general partnership statute, see *id.* §§ 2.02, 9.01.

Texas requires the entity to set out a plan of conversion that must be approved. See TEX. REV. CIV. STAT. ANN. art. 1528n, § 10.08(C) (West 1998). If the plan of conversion is approved then a representative of the entity must execute articles of conversion that set forth:

- (1) the plan of conversion . . . certifying the following:
 - (a) the name, the state of incorporation, formation, or organization of the converting entity, and the organizational form of the converting entity;
 - (b) that a plan of conversion has been approved;
 - (c) that an executed plan of conversion is on file at the principal place of business of the converting entity . . . and;
 - (d) that a copy of the plan of conversion will be furnished by the converting entity (prior to the conversion) or the converted entity (after the conversion), on written request and without cost, to any shareholder, partner, or member of the converting entity or the converted entity;
- (2) a statement that the approval of the plan of conversion was duly authorized by all action required by the laws under which the converting entity was incorporated, formed, or organized and by its constituent documents; . . .

Id. § 10.09(A).

338. See, e.g., N.Y. LTD. LIAB. CO. LAW §§ 1006, 1007 (McKinney Supp. 1999); TEX. REV. CIV. STAT. ANN. art. 1528n, § 10.09(A)(2) (West Supp. 1999). New York's default rule requires unanimous consent in the conversion of a general partnership to a LLC:

Subject to any requirements in the partnership agreement requiring approval by any lesser percentage in interest of partners, an agreement of conversion setting forth the terms and conditions of a conversion of a partnership to a limited liability company *must be approved by all of the partners of the partnership.*

N.Y. LTD. LIAB. CO. LAW § 1006(c) (McKinney Supp. 1999) (emphasis added).

New York has special rules for converting from a limited partnership. Absent a contrary agreement, general partners must unanimously consent to the conversion. At least two-thirds of limited partners must consent if there is no agreement to the contrary. In any case, an agreement cannot specify a percentage of limited partner approval that is less than the approval of the majority-in-interest. See *id.* § 1006(c).

The effect of such a conversion should not penalize the entity, but rather protect creditor and state interests.³³⁹ First, the entity should continue to exist, without interruption.³⁴⁰ Second, the conversion should not disrupt any property interests, real or personal, that the entity held prior to conversion.³⁴¹ Third, conversion statutes should protect creditors by transferring all debts and obligations of the old entity to the new entity.³⁴² Fourth, parties to a conversion should not have to assume personal liability, unless they have agreed to do so in writing³⁴³ or unless the party was liable under prior law in the converting entity.³⁴⁴ Fifth, all proceedings against the old entity should continue as to the new entity.³⁴⁵ And sixth, unless otherwise agreed, all partners or shareholders of the previous entity should be members in the LLC.³⁴⁶ Universal conversion provisions allow for quick, painless conversion from a state law perspective.

B. FEDERAL TAXATION ISSUES IN CONVERSION

Presently, if a close corporation were to find converting to an LLC desirable, there may be serious federal tax consequences for doing so. The corporation would have to liquidate then file for LLC status under state law (pursuant to the universal conversion provision, if in a state like Texas).³⁴⁷ In a complete corporate liquidation, the corporation must recognize any gain or loss on property distributed to the extent the fair market value of the property exceeds the adjusted basis.³⁴⁸ Similarly, shareholders must report gain recognized in the liquidation,³⁴⁹ which will be long term capital gain if the stock is held for more than one year.³⁵⁰ Moreover, if the shareholders intend to continue the existing business organized as an LLC, they may have to determine the value of the business

339. A good example of the effect of an LLC conversion is set forth in the New York statute: "A partnership or limited partnership that has been converted . . . is for all purposes the same entity that existed before the conversion." N.Y. LTD. LIAB. CO. LAW § 1007 (McKinney Supp. 1999). Instead of limiting the statute to "partnership or limited partnership," statutes should include all forms of business, including corporations. *Id.*

340. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 1528n, § 10.11(A)(1) (West Supp. 1999).

341. *See, e.g.*, N.Y. LTD. LIAB. CO. LAW § 1007(b)(i) (McKinney Supp. 1999).

342. *See, e.g., id.* § 1007(b)(ii); *see also* TEX. REV. CIV. STAT. ANN. art. 1528n, § 10.11A(3) (West Supp. 1999) ("[A]ll liabilities and obligations of the converting entity shall continue to be liabilities and obligations of the converted entity in its new organizational form without impairment or diminution by reason of the conversion."); *Id.* § 10.11A(1) (providing that all rights of creditors prior to the conversion carry full effect as though the conversion did not happen).

343. *See id.* § 10.11A(7)(a).

344. *See id.* § 10.11A(7)(b).

345. *See, e.g.*, N.Y. LTD. LIAB. CO. LAW § 1007(b)(iii) (McKinney Supp. 1999).

346. *See, e.g., id.* § 1007(b)(iv) (McKinney Supp. 1999).

347. *See supra* text accompanying notes 337-46.

348. *See* I.R.C. § 336 (1999). *See generally* George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 TAX L. REV. 574 (1987) (analyzing corporate liquidations after the 1986 Tax Reform Act).

349. *See* I.R.C. §§ 331, 1001 (1999).

350. *See id.* §§ 1221, 1222 (1999).

as a going concern.³⁵¹ The foregoing would be true also for S Corporations since subchapter S sends all corporate liquidation questions to subchapter C.³⁵²

Formation of an LLC after a complete liquidation and contributions of property into the new LLC would be tax-neutral events.³⁵³ Gain or loss on property contributed to the LLC would not be recognized.³⁵⁴ Members will take an exchanged basis in their LLC interest,³⁵⁵ and the LLC will take a transferred basis in the contributed property.³⁵⁶

A general partnership or limited partnership would face similar tax pressures in converting to an LLC,³⁵⁷ but, through Revenue Rulings 84-52³⁵⁸ and 95-37,³⁵⁹ the Service has allowed such partnerships to convert without adverse tax consequences.³⁶⁰ The effect of these revenue rulings is that no gain or loss is recognized as a result of the conversion, there is no change in the adjusted basis of any partner's basis, and the holding period of a partner's total interest remains the same.³⁶¹ In fact, the new LLC will not even need to apply for a new taxpayer identification number.³⁶²

There is good justification for the Service to adopt a ruling similar to Revenue Rulings 84-52 and 95-37 that would benefit corporations.³⁶³

351. The shareholders would have to assess not only the fair market value of the assets of the liquidating corporation, but also the value of the accumulated good will that the business had developed. See Rev. Rul. 59-60, 1959-1 C.B. 237; see also I.R.C. § 1060 (1999). See generally ROHRLICH, *supra* note 90, § 3.14[2].

352. See I.R.C. § 1371 (1999).

353. See *id.* § 721(a) (1999); Treas. Reg. § 301.7701-3 (1998).

354. See I.R.C. § 721(a) (1999). But property that was distributed to shareholders through the corporate liquidation will have a fair market value basis in the hands of the shareholders. See I.R.C. § 334(a) (1999). This nonrecognition rule is only necessary for property contributed to the LLC that was not distributed as part of the corporate liquidation.

355. That is, the member will exchange the basis in the contributed property for the basis in the LLC interest. See I.R.C. § 722 (1999).

356. That is, the LLC's basis in the property will be the basis as it was in the hands of the member immediately prior to contribution. See *id.* § 723 (1999). If the corporate liquidation and LLC formation are part of the same transaction, the basis will be the fair market value of the property since the member will have a fair market value basis from the liquidation. See *id.* § 334(a) (1999).

357. A partner must recognize gain or loss on the sale or exchange of his partnership interest. See *id.* §§ 741, 1001 (1999).

358. Rev. Rul. 84-52, 1984-1 C.B. 157. Revenue Ruling 84-52 deals with conversions from general partnerships to limited partnerships and from limited partnerships to general partnerships.

359. Rev. Rul. 95-37, 1995-1 C.B. 130. Revenue Ruling 95-37 adopted the 84-52 Ruling for general partnerships and limited partnerships converting to the LLC.

360. See Rev. Rul. 84-52, 1984-1 C.B. 157; see also Rev. Rul. 95-37, 1995-1 C.B. 130.

361. See Rev. Rul. 84-52, 1984-1 C.B. 157; Rev. Rul. 95-37, 1995-1 C.B. 130.

362. See Rev. Rul. 95-37, 1995-1 C.B. 130.

363. See generally Hamill, *The Limited Liability Company*, *supra* note 8, at 415, 430; AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES, Memorandum No. 3, 3-12 (September 10, 1997) (on file with author). There is resistance to this approach. For instance, the Clinton budget proposal includes a "[r]epeal of tax-free conversions of large C Corporations to S corporations." Ryan J. Donmoyer et al., *The Clinton Budget: A Tax Increase Based on Shaky Revenue-Raisers*, 78 TAX NOTES 639, 640 (1998).

The current system of double taxing closely held corporations is unfair for two reasons. First, it unfairly double taxes unsophisticated businesses and allows sophisticated businesses to escape double taxation by paying out earnings in deductible items like salaries, rent, or interest.³⁶⁴ Second, the "current system for imposing the corporate tax on nonpublicly traded businesses employs a double standard based on whether the business has incorporated under state law."³⁶⁵ Providing tax-free conversion to the LLC will bring the check-the-box regulations full circle, and it will provide an equal playing field for closely held businesses.³⁶⁶

An alternative solution, as presented by Professor Walter D. Schwidetzky, contemplates the wholesale repeal of subchapter S.³⁶⁷ Although Congress has substantially changed subchapter S in recent years,³⁶⁸ it is an outmoded provision of the Code that is still fundamentally flawed.³⁶⁹ Professor Schwidetzky suggests that current S corporations should be given five years to convert to an unincorporated organization or alternatively to remain a corporation and become a C corporation. This proposal would have essentially the same effect as Revenue Rulings 84-52 and 95-37, but the repeal of subchapter S would eliminate future confusion by removing a potential trap for the unwary business person.

Thus, Congress should repeal subchapter S and allot S corporations a period of time to make a tax-free conversion to an unincorporated entity. If Congress does not repeal subchapters, the Service should issue revenue rulings similar to 84-52 and 95-37, which would allow for tax-neutral conversion from a corporation to an LLC. Either approach gives parties the freedom to choose business form without intrusive tax burdens.

C. STATE TAXATION SHOULD MIRROR THE CHECK-THE-BOX FORMAT

Finally, the check-the-box regulations also provide an opportunity for states to reexamine their business enterprise laws and taxation system. Many states still have classification systems similar to the *Kintner* Regula-

364. See Hamill, *The Limited Liability Company*, *supra* note 8, 415, 430. Such a system "violate[s] fundamental principals of horizontal equity." *Id.* at 431.

365. *Id.* at 429; see also American Law Institute, *supra* note 363.

366. See Hamill, *The Limited Liability Company*, *supra* note 8, at 433 ("Only after lawmakers integrate close corporations, thus removing the tax advantage LLCs currently enjoy, can new businesses choose between the LLC and the closely held corporation without regard to tax consequences. . .").

367. See Schwidetzky, *supra* note 44, at 636-38.

It is not worth the statutory effort to retain subchapter S merely because the S corporations [sic] possesses a few advantages in limited circumstances over LLC's. The legal landscape is complex enough. The Service, the court system, and tax professionals do not need to be burdened by marginally beneficial statutes and regulations. The time of the S corporation has past. . . . A major blow for tax simplification would be struck by repealing subchapter S of the Code.

Id. at 638

368. See *id.* at 626-36; see also 2 HOOD & MYLAN, *supra* note 44, § 24:01.

369. See *supra* text accompanying notes 42-48.

tions.³⁷⁰ Thus, states that have such a system would tax an LLC as a corporation if it had more than two of the following *Kintner* characteristics: limited liability, transferability of interest, continuity of life, and centralized management. This proposal argues that the state taxation classification system should mirror the check-the-box regulations. In other words, states should allow unincorporated organizations to elect their tax classification—corporation or partnership—for state tax purposes.

Failure to do this will place serious financial complications in the path of an entity seeking to convert. This is especially true of partnerships since they are taxed on a flow-through basis under state law. Conversion to an LLC in a state that has an entity tax on an LLC would create annual tax liability for the partnership, which can often be substantial. Hence, partnerships may opt out of converting since that would add to the entity's state tax liability.

While many states have already converted to the check-the-box model,³⁷¹ there are legitimate problems that stand in the way of some states making such a change.³⁷² For example, states without a personal income tax—like Texas—may choose not to conform to check-the-box.³⁷³ Replacing an entity-level tax with pass-through taxation would allow an LLC to escape taxation altogether. Thus, these states may continue to tax LLCs as corporations or have some other entity level tax.³⁷⁴ This could prevent LLCs from maximizing the benefits of the federal check-the-box regulations; it will also damage the effectiveness of this three-statute proposal.³⁷⁵

V. CONCLUSION

Present day statutory schemes for business organizations may have been considerably less complex had the federal tax pressures been less overt. Statutory forms like the close corporation, LLP, LLC and LLLP are examples of the complexities that have developed. State legislatures should take the opportunity that the check-the-box regulations presents

370. See *supra* text accompanying 54-62.

371. For a list of states that have adopted the check-the-box style of classification for state taxation purposes see Bruce P. Ely & Christopher R. Grissom, *The LLC/LLP Score Card*, 98 TNT 225-72, Nov. 23, 1998, available in LEXIS, FEDTAX Library, TNT File.

372. Several states apply a franchise tax to LLCs. As of the writing of this article, they include: Kansas, Ohio, Texas, and West Virginia. See *id.* California, effective October 1, 1997, Florida, effective July 1, 1998, and Pennsylvania, effective January 1, 1998, have recently adopted policies that reflect the federal check-the-box regulations. See *id.*

373. "Corporate tax treatment for LLCs is necessary to ensure the taxation of the LLC. Otherwise, an LLC would be taxed as a passthrough entity and could escape state taxes altogether because no income tax is assessed at the individual level." Thomas M. Hayes, Comment, *Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and their Effect on Entity Classification*, 54 WASH. & LEE L. REV. 1147, 1179 n.222 (1997) (citations omitted).

374. For example, Texas subjects LLCs to the corporate franchise tax. See Ely & Grissom, *supra* note 371, at 225-72.

375. See Hayes, *supra* note 346, at 1178-80.

to revisit their statutes. An analysis of current business issues leads to a more simplified approach.

But Professor Ribstein, for one, disagrees with this approach.³⁷⁶ He claims that while narrow-thinking tax lawyers may agree that statutes should be simplified,³⁷⁷ business lawyers have real-world reasons for maintaining separate statutes.³⁷⁸ Specifically, he points to the family limited partnership as one such “clientele” of business association that would benefit from diverse statutes.³⁷⁹ He asserts that the limited partnership should remain on the books because the dissolution rules in the LLC would cause the family business to receive less favorable treatment under the Code’s valuation rules.³⁸⁰ This Comment has shown, however, that state legislatures can safely eliminate dissolution rules if legislatures also draft minority protection rules into the LLC statute.³⁸¹ Further, family businesses should not be forced to select a general partner; they should receive the LLC’s limited liability and flexibility benefits as well.³⁸²

Two business forms remain fundamental: the corporation and the partnership. These historic business forms should remain largely intact. Other forms, like the LLP, limited partnership, and close corporation have become outdated. The LLC should be amended to become hospitable to the “clienteles”³⁸³ of each of these forms. As such, the simplified approach legislatures should take should include only the general partnership, the LLC, and the corporation.

376. See *Check-the-Box and Beyond*, *supra* note 6, at 612; Ribstein, *New Choice of Entity*, *supra* note 164, at 334-35.

377. See Ribstein, *New Choice of Entity*, *supra* note 164, at 334 (“Tax lawyers may believe that . . . there is no further reason to have many different types of business association statutes. I would compare this to the famous cover of the *New Yorker* magazine that portrayed a *New Yorker*’s view of the United States, with the Hudson River where the Mississippi should be.”).

378. See *id.* at 335.

379. See *id.* at 335-43.

380. See *id.* at 338-40.

381. See *supra* text accompanying notes 295-301.

382. See *supra* text accompanying notes 122-30 and 290-94.

383. See *supra* text accompanying note 21.

