The Silent LLC Revolution—The Social Cost of Academic Neglect

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The law of Business Associations usually develops slowly. The business forms that dominated the business landscape until the end of the 20th century have been in existence for hundreds of years.[1] However, in the last decade a revolution has taken place. The Limited liability Company has become the dominant form for newly-created small businesses in a clear majority of the states, and is rivaling corporations for that distinction in several more. Nationwide, over 45% of new businesses are LLCs.[2] Yet reading the legal literature, one would never suspect this.

Several years ago, Prof. John W. Lee published a study comparing the number of corporations formed between 1995 and 1998 with the number of limited liability companies formed in the same time period. He concluded that in those years, "in all but one state new corporation formations … outnumber new LLC formations—usually by a margin of 2:1 or 3:1 or greater."[3] As the statistics discussed in this article demonstrate, at least by 2002, the picture changed dramatically.

The LLC revolution has not only occurred with lightening speed. Equally interesting is the fact that the revolution has been carried forward primarily by

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[1] See Thomas Lee Hazen & Jerry W. Markham, CORPORATIONS AND OTHER BUSINESS ENTERPRISES 1-4 (2003).

[2] See Sec. I, *infra*.

[3] John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do"*, 78 Tex. L. Rev. 885, 887 (2000).

practitioners.[4] Law schools, law professors, law publishers, bar examiners and others usually responsible for disseminating cutting edge developments have been surprisingly absent from the playing field much of the time. In 2004, they remain in denial, acting as if the general partnership were still the chief rival to the corporation. In the 21st century, they still live in the 1990's. In Part IV of this article I examine why this group of usual early-adopters still remains in denial.

This article begins by examining the data—something that, except for Prof. Lee's article, has only occasionally been done in the academic literature.[5] Next, I examine the history of limited liability companies in the United States and explain why the LLC has become such a popular business form. In Part III, I examine why this new business form has failed to catch hold in a few key states. Part IV examines the absence of interest in the LLC form by scholars, law schools, law publishers and bar examiners and attempts to analyze why this is the case. Part V makes a plea for academics to focus on their attention on limited liability companies and suggests some urgent topics for law reform and their research agendas.

I.

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[4] For theoretical analysis of why lawyers are a powerful force in seeking LLC legislation, see Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 Wash. U. L.Q. 369, 392-94, 400-01 (1995).

[5] Among the few other attempts to do more than merely make passing reference to the increasing numbers of LLCs and instead analyze empirical data on LLCs are Larry E. Ribstein, *supra* note [4] at 428-30; Conrad S. Ciccotello & C. Terry Grant, *LLCs and LLPs: Organizing to Deliver Professional Services*, Business Horizons, March/April 1999, Pg. 85; Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 Wm & Mary L. Rev.79 (2001); 1 Ribstein & Keatinge, LIMITED LIABILITY COMPANIES §1.1 AT FN 1 (2003); Sandra K. Miller, *A New Direction For LLC Research In a Contractarian Legal Environment*, 76 S. Cal. L. Rev. 351 (2003) (reporting on a survey of 770 attorneys asking about their use of and experience with LLCs); Peter B. Oh, *A Jurisdictional Approach to Collapsing Corporate Distinctions*, 55 Rutgers L. Rev. 389, 398-99 (2003).

The Data

The International Association of Commercial Administrators collects data from almost all states on the number of business filings made annually in each state.[6] The latest data set available is for 2003.[7] That data, with other reports and data sources, allow me to compile comparative statistics for all 50 states plus the District of Columbia. As the following tables demonstrate, the growing predominance of LLCs was obvious by 2002, when they comprised a majority of new business filings in 19 states and made up 41.84% of business filings nationwide. By 2003, the predominance of LLCs was unquestionable. In that year, more LLCs than corporations were formed in 29 states. In 11 other states where corporations predominated, over 45% of new business filings still were for LLCs. In almost all the states, the percentage of businesses choosing the LLC form increased from the prior year.

In the remaining eleven jurisdictions, while the use of LLCs increased, corporations clearly were still the form of choice. In six states, this was overwhelmingly so: in California, Florida, Illinois, New York, North Dakota and South Dakota, over twice as many corporations as LLCs were formed in 2003. However, as will be discussed in Part III, in many of these cases special peculiarities of state law or practice explain why LLCs have not become more popular.

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[6] IACA is an association of state, provincial and national government administrators of business entity and secured transaction record systems. Its web site is at http://www.iaca.org.

[7] *IACA 2004 Annual Report of the Jurisdictions,* (Corporation Service Company). Data in this article is also taken from *IACA 2003 Annual Report of Jurisdictions*, http://www.iaca.org/doc/annual_report_of_jurisdictions_-_iaca_2003_.pdf. Detailed data, including explanations of numbers taken from other sources, are set out in the Appendix to this article.

Nationally, 45.44% of business filings in 2003 were for LLCs. If we exclude the six states in which LLCs have clearly not become widely accepted, 53.72% of the business filings in the remainder of the country were for LLCs.

The 29 States Where LLCs Predominate
(Domestic and Foreign Filings)
(See Appendix A for Details of Data)

State	% LLCs 2002	% LLCs 2003
Connecticut	81.50%	81.65%
Wisconsin	71.20%	75.61%
Louisiana	66.63%	72.53%
New Hampshire	64.11%	65.23%
Ohio	59.22%	65.23%
Arizona	60.84%	64.90%
Missouri	56.82%	63.73%
Michigan	55.22%	61.35%
Oregon	55.02%	61.19%
New Jersey	52.67%	60.73%
Delaware	56.22%	60.01%
New Mexico	53.92%	59.88%
Montana	N/A	59.20%
Kentucky	53.13%	58.53%
Alaska	46.86%	57.13%
Utah	52.27%	57.00%
South Carolina	51.03%	56.54%
Oklahoma	50.38%	55.67%
Mississippi	49.27%	55.32%
Alabama	47.98%	55.01%
Washington	50.23%	54.88%
Idaho	51.07%	54.77%
Kansas	48.22%	53.96%
Hawaii	48.34%	53.17%
Rhode Island	43.66%	52.33%
Maryland	45.07%	51.20%
Virginia	45.06%	50.85%
Iowa	44.81%	50.59%
Indiana	45.20%	50.14%

The 16 Jurisdictions Where LLCs Are Popular But Not Predominant
(Domestic and Foreign Filings)
(See Appendix A for Details of Data)

State	% LLCs 2002	% LLCs 2003
Colorado	49.34%	50.00%
Vermont	52.69%	49.48%
Tennessee	43.99%	48.24%
Wyoming	44.67%	48.10%
West Virginia	46.92%	47.84%
Minnesota	37.33%	47.19%
Maine	34.84%	46.84%
Georgia	40.72%	46.45%
Arkansas	40.22%	46.00%
Nebraska	39.13%	45.86%
North Carolina	40.99%	45.50%
Pennsylvania	37.58%	44.03%
District of Columbia	43.82%	43.89%
Nevada	35.18%	40.32%
Massachusetts	32.23%	40.13%
Texas	36.66%	39.04%

6 States With Corporations = 2x LLCs
(Domestic and Foreign Filings)
(See Appendix A for Details of Data)

State	% LLCs 2002	% LLCs 2003
New York	29.19%	32.87%
California	29.40%	32.58%
Illinois	25.23%	31.00%
Florida	21.39%	27.08%
South Dakota	17.47%	20.01%
North Dakota	27.79%	14.56%

This data is not perfect. We would like to know the comparative number of domestic corporations vs. domestic limited liability companies, i.e. the comparative number of businesses that were formed under the law of each state. The IACA data lists this for corporations. It then lists separately the number of foreign (out-of-state) corporations that filed to qualify to do business in the state.[8] For LLCs, the IACA data combines the number of new LLCs formed in the state with the number of foreign LLCs

[8] State laws typically require both out-of-state corporations and out-of-state LLCs that transact business in the state to file with the secretary of state, pay a filing fee and appoint an agent for service of process in the state. See e.g. MBCA §§15.01- 15.05; Uniform Limited Liability Company Act §§1002-1004.

that have filed to qualify to do business in the state. Thus some LLCs are counted more than once—once in the state of formation and again in each foreign state in which it is doing business. To make the data set out above comparable, I have compared the combined LLC data with the combined numbers for domestic incorporations plus foreign corporations qualifying to do business. This comparison very likely understates the dominance of LLCs in new business formation. Larger businesses are more likely to operate beyond their state of formation. The larger the business, the more likely it is to be in corporate form. Stated another way, it is probable that a smaller percentage of LLCs than corporations qualify to do business in a state outside their state of formation.

This is largely borne out by figures for those few states that elsewhere report in more detail. In Kentucky in 2003, for example, 6,799 new corporations were formed, while 2,360 foreign corporations filed. On the other hand, 11,878 new LLCs were formed (almost 75% more LLCs that corporations), but only 1,050 foreign LLCs qualified to do business in the state (55% fewer than the number of foreign corporation filings).[9] Similar data is available from Arizona. 13,075 domestic corporations were formed and 2,483 foreign corporations qualified to do business in the state in 2003. Compared to that, 27,056 domestic LLCs were formed and only 1,706 foreign LLCs qualified to do business in the state.[10] Interestingly, as might be expected, this pattern may not hold true for the six states in which LLCs have not been wieldy accepted. In Illinois, 18,772 domestic LLCs were formed in 2003, and 2,678 foreign LLCs qualified

[9] KY Secretary of State Annual Business Filing Statistics, http://www.kysos.com/BUSSER/BUSFIL/annualstatistics.asp (visited 7/13/04).

[10] Data obtained from Ariz. Corp. Comm., Corporations Division website, http://www.cc.state.az.us (“Information on Active Corporations”/ “Statistics”) (last visited 8/26/04).

to do business in the state. In the same year 44,384 domestic corporations were formed, and only 3,387 foreign corporations qualified to do business in Illinois.[11]

II.

The Limited Liability Company

A. An Introduction to LLCs

In order to understand the importance of limited liability companies one must step back and survey broadly the forms that are available for conducting business. Historically, the major choices for individuals going into business were the partnership and the corporation. Choosing which of the two forms to use involved balancing business considerations and tax factors. Partnerships sometimes offered the most attractive federal income tax features; but business factors—particularly the lack of limited liability in the partnership—often drove entrepreneurs to choose the corporate form even for small businesses.[12]

In reality, the choice was not that stark. On the tax side, before the reduction of personal income tax rates in 1986[13], corporate taxation was far from disadvantageous if all profits were to be reinvested in the business.[14] Earnings would be taxed at corporate rates that were typically significantly lower than personal rates. The value of stock in the

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[11] IL data obtained through e-mails from Robert Durchholz, Dept. of Business Services, Illinois Secretary of State's Office (July 21 and 22, 2004).

[12] See generally, Larry D. Soderquist, Linda O. Smiddy, A.A. Sommer, Jr. & Pat K. Chew, CORPORATE LAW & PRACTICE, Chap. 3 (2d ed., 1999).

[13] See *Highlights of Tax Reform Act of 1986,* 1986 U.S. Tax Week 625 (Oct. 13, 1986).

[14] Prior to 1986, marginal personal tax rates were significantly higher than corporate rates. Incorporating, reinvesting earnings in the business and realizing the gain ultimately as capital gain (taxed at a lower rate, or not at all if shares were held until death) was often a preferred strategy. However, a number of anti-evasion provisions in the Internal Revenue Code limited the extent to which this could be done. See generally, George C. Seward, BASIC CORPORATE PRACTICE 12-24 (1966).

hands of shareholders would increase and eventually that gain would be taxed at low capital gains rates or, if the stock was held until death, it would get a stepped-up basis and the capital gains would not be taxed at all.[15]

Even if corporate earnings were to be distributed to investors, many small corporations could elect to be taxed under Subchapter S of the Internal Revenue Code and receive some of the important benefits that are present in the tax treatment of partnerships.[16] Alternatively, without choosing Subchapter S, for corporations outside certain personal service industries a portion of the corporation's earnings could be sheltered at the low rates applicable to the first $50,000 or $75,000 of corporate income.[17] Shareholders could often limit the corporation's earnings to that amount by taking the rest as salary taxable to the shareholder-employee, but deductible by the corporation as a business expense.[18]

On the other hand, choosing the partnership was not as disadvantageous from the business perspective as the theory of limited liability might seem to suggest. In reality, the owners of close corporations often were required to personally guarantee bank loans and other major obligations of the corporation, eliminating their limited liability for the most important of the business' contractual obligations.[19] When it came to tort claims,

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[15] IRC §1014 provides that stock acquired from a decedent will acquire a basis equal to its fair market value at the date of the shareholder's death.

[16] IRC §1361- §1379. See generally I Borris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, Chap. 6 (7th ed., 2003).

[17] IRC §11(b).

[18] John W. Lee, *supra* note ___ at 910-22.

[19] See e.g. Sartino v. First Alabama Bank, 435 So. 2d 39 (Sup. Ct. Ala., 1983); State Bank of Parsons v. Elliott, 447 P.2d 778 (Sup. Ct. Okl., 1968); Bennett v. First Nat'l Bank, 194 S.E.2d 903 (Sup. Ct. Va., 1973). Also see Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 Northwestern U. L. Rev. 140, 154-55 (1994).

again the real world was more complex than theory. Since the shareholder-entrepreneur often was a primary employee of the business, many of the torts chargeable to the business would be committed, at least in part, by that owner. For those torts, the shareholder-tortfeasor remained personally liable as do all tortfeasors.[20] Finally, both corporations and partnerships typically took out insurance to cover tort claims, so that the real personal risk for tort liability to partners was only liability for the smaller universe of claims that exceeded the policy limits of the business.[21]

Nevertheless, the standard choice between a general partnership and a corporation was not optimal. Before the rise of LLCs, a number of intermediate forms of business arose that went part of the way toward providing both partnership tax treatment and limited liability. The limited partnership,[22] the limited liability partnership,[23] and the limited liability limited partnership[24] were all intermediate—albeit sometimes cumbersome—forms. While these intermediate forms became popular in a few specialized kinds of businesses[25] and professional firms[26], none of them became a

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[20] See Richard A. Booth, *supra* note __ at 155-56; *Restatement (Third) of Agency* §7.01 (T.D. No. 5, 2004).

[21] Corporate shareholders are not totally without risk. When corporate assets and insurance are inadequate, tort claimants sometimes attempt to pierce the corporate veil and get to shareholders' individual assets. See e.g. Radaszewski v. Telecom Corp, 981 F.2d 305 (8th Cir., 1992); In re Death of Smithour, 778 P.2d 302 (Colo. Ct. App., 1989); Walkovsky v. Carlton, 223 N.E.2d 6 (NY Ct. App., 1966).

[22] See Uniform Limited Partnership Act (2001).

[23] See Uniform Partnership Act (1997), §306(c), §§1001- 1105.

[24] See Uniform Limited Partnership Act (2001), §201(a)(4), §404(c).

[25] Limited partnerships were widely used in oil and gas exploration, real estate investment, equipment leasing, motion picture financing and other tax shelters. See Craig B. Smith & Anne Bookout Horgan, *Limited Partnerships: Legal Aspects of Organization, Operation, and Dissolution,* 24-3d C.P.S. (BNA) at A-2 (1994).

[26] Limited liability partnerships became popular with law firms and accounting firms. See Charles R. Wolfram, *Inherent Powers in the Crucible of Lawyer Self-Protection: Reflections on the LLP Campaign,* 39 S. Tex. L. Rev. 359 (1998); Jonathan Macey & Hillary A. Sale, *Observations on the Role of*

widespread substitute for the corporation and partnership in the broad universe of small business ventures.[27] Only the limited liability company (LLC)—a hybrid melding the corporation and the partnership-- gained that distinction. Yet some of the leading academic literature and materials designed to educate law students—even that published in 2002 or after—still give limited partnerships and limited liability partnerships equal or superior billing to LLCs.[28]

The limited liability company, which came of age in the 1990's, presented the entrepreneurs of Generation X with their ultimate dream. With the LLC, they could have it all—partnership tax, limited liability, and default rules more suited to the small business than are the corporate default rules. Indeed this last point is often overlooked, but it is an extremely important consideration in the use of LLCs.

Corporations were created primarily to facilitate the amassing of capital from large numbers of investors.[29] Corporate law developed both mandatory and default rules designed to protect geographically dispersed passive investors from the shirking, self-

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Commodification, Independence, and Governance in the Accounting Industry, 48 Vill. L. Rev. 1167 (2003).

[27] See discussion in Part IV, *infra.*

[28] E.g. William A. Gregory & Thomas R. Hurst, UNINCORPORATED BUSINESS ASSOCIATIONS (2nd ed., 2002) (limited partnerships- 80 pages; LPPs- 2 pages; LLCs- 46 pages); Robert W. Hamilton & Jonathan R. Macey, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES (8th ed., 2003) (limited partnerships- 26 pages; LLPs- 7 pages; LLCs- 27 pages); Thomas Lee Hazen & Jerry W. Markham, CORPORATIONS AND OTHER BUSINESS ENTERPRISES (Standard Edition, 2003) (limited partnerships- 12 pages; limited liability partnerships- 3 pages; LLCs- 13 pages). In two recent casebooks, the pages devoted to LLCs outnumbered those devoted to LPs and LLPs by the tiniest margin: J. Dennis Hynes & Mark J. Loewenstein, AGENCY, PARTNERSHIP AND THE LLC: THE LAW OF UNINCORPORATED BUSINESS ENTERPRISES (6th ed., 2003) (limited partnerships- 65 pages, limited liability partnerships- 2 pages; LLCs- 71 pages); D. Gordon Smith & Cynthia A. Williams, BUSINESS ORGANIZATIONS (2004) (limited partnerships- 9 pages; limited liability partnerships- 10 pages; LLCs- 23 pages). For the more important comparison of casebook coverage of LLCs in relation to corporations, see Sec. __ *infra.*

[29] See e.g. Austin v. Mich. State Chamber of Commerce, 494 U.S. 652, 664 (1990); Christian C. Day, *Partner to Plutocrat: The Separation of Ownership from Management in Emerging Capital Markets -- 19th Century Industrial America*, 58 U. Miami L. Rev. 525 (2004).

dealing and incompetence of those managing the pooled funds originally invested by shareholders.[30] A number of these rules are unsuited to the small business where there is no separation of ownership and management. Annual election of managers[31]; the requirement that decisions generally be made in formal meetings[32]; the requirement that minutes of meetings be kept[33]; a separation of powers that give separate roles to owners, day-to-day managers, and a board that sets policy and monitors management[34]; free transferability of ownership interests in exchange for locking capital investment into the business[35]—these are traps for unwary closely held business owners, not their protective armor.

Partnership law, on the other hand, is designed for the business in which owners are also managers. Its default rules facilitate the permanent appointment of managers,[36] informal decision making,[37] control over the identity of new co-owners,[38] and the ability

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[30] See generally, I James D. Cox, Thomas Lee Hazen & F. Hodge O'Neal, CORPORATIONS, Chap 10 (1998) (discussing duties of care and loyalty). Cf. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999) (role of directors is not to reduce agency costs, but to encourage team production).

[31] MBCA §8.03(c).

[32] MBCA §7.25, §8.20. But see MBCA§7.04 and §8.21 permitting unanimous consent in writing in lieu of a formal meeting.

[33] MBCA §16.01(a).

[34] See Melvin Aron Eisenberg, THE STRUCTURE OF THE CORPORATION (1976).

[35] See Margaret M. Blair, *Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. Rev. 387 (2003); Lynn A. Stout, *On the Nature of Corporations,* (July 2004). UCLA School of Law, Law-Econ Research Paper No. 04-13. http://ssrn.com/abstract=567803.

[36] Uniform Partnership Act (1997), §301, §303.

[37] Uniform Partnership Act (1997), §101(7), §401(j).

[38] Uniform Partnership Act (1997), §401(i).

to withdraw capital in the event of disagreement with management decisions.[39] These features are the hallmark of small business needs in the real world. Of course, many of the inconvenient corporate default rules could be changed through lawyering. Provisions in articles and bylaws, shareholder agreements[40] and buy-sell agreements can make the corporation's operating guidelines similar to those automatically available by default in the partnership. An ill-fitting suit can be tailored to fit fairly well; but one that fits off the rack is usually less costly and overall a better choice. Sometimes though, the color or style of the ill-fitting suit is so attractive that extensive tailoring is appealing. Before LLCs, many were willing to tailor the ill-fitting corporate cloak in order to get one appealing feature that was unavailable in the partnership—limited liability.

The limited liability company offers the default rules of partnerships along with limited liability. Moreover, at least beginning in 1997, all of this became available with the advantage of partnership taxation to boot.[41] Small businesses have flocked to the LLC. Limited liability companies are also frequently used by larger businesses when corporations wish to create wholly-owned subsidiaries. Just as the LLC is a convenient vehicle for a single individual as an owner, so they are convenient for a single corporate parent to use.[42]

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[39] Uniform Partnership Act (1997), §801, §807.

[40] See MBCA §7.32.

[41] Effective Jan. 1, 1997, the Internal Revenue Service adopted the so-called "Check-the-Box" Regulations, IRS Reg. §301.7701-2, §301.7701-3. Taxation of LLCs is discussed further in Section ___, *infra*.

[42] See Barbara Ann Banoff, *Company Governance Under Florida's Limited Liability Company Act*, 30 Fla. State U. L. Rev. 53, 56 n.17 (2002).

B. The Invention of the LLC—A Practitioner-Driven Revolution While Academics Were Looking In the Other Direction

Limited liability companies were not the invention of academic scholars. Indeed, beginning in 1980 a number of scholars, using insights from the law and economics movement, began to question the wisdom of limited liability. Many of these scholars suggested that limited liability for torts caused corporations at the behest of their shareholders to take excessive risks, knowing that the upside potential was unlimited while downside exposure was limited to assets invested in the enterprise.[43] This academic interest in expanding personal liability of shareholders for torts committed by their corporations peaked with a classic 1991 article by Professors Henry Hansmann and Reinier Kraakman.[44]

But the expansion of personal liability for torts did not sit well with practicing lawyers of that decade. 1991 was just the time at which unincorporated law and accounting firms, plagued by their participation in the savings and loan scandal, began to cry for protection from personal liability for malpractice claims.[45] In that year, Texas adopted the first Limited Liability Partnership law, allowing partners to shield themselves

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[43] E.g. Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 Yale L. J. 1, 65-76 (1980); Alan Schwartz, *Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship*, 14 J. Legal Studies 689, 714-28 (1985).

[44] Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability For Corporate Torts,* 100 Yale L.J. 1879 (1991).

[45] Robert W. Hamilton, *Registered Limited Liability Partnerships: Present At the Birth (Nearly),* 66 U. Colo. L. Rev. 1065 (1995)

from tort liability, but not contract, liability—the exact opposite of the policy that academics were advocating.[46]

Just as intermediate forms like LLPs were impelled by lawyers "in the trenches", so were the first LLCs. Limited liability companies originated with practicing lawyers representing specific clients. Prof. Susan Pace Hamill has traced the early history.[47] Some individuals had, in the past, been involved in oil and gas exploration using a Panamanian "Limitada", a business form giving investors limited liability, but taxed as a partnership under U.S. tax law. They asked their lawyers why there was not a similar business form available under U.S. law. Their lawyers promptly set out to find a state legislature that would create the business form for their clients. Initial attempts to convince the Alaska legislature to do so failed in 1975 and 1976. Understanding, however, that different states can be laboratories for experimentation, the lawyers moved their efforts to Wyoming and, in 1977, succeeded. Wyoming enacted the first limited liability company statute.[48]

This was only the first battle in the lawyers' campaign for their clients. Next they needed to obtain agreement of the Internal Revenue Service that the new Wyoming form of business would receive partnership tax treatment. The lawyers embarked on a three-year campaign to achieve this, in the process enlisting the aid of the Secretary of State and Governor of Wyoming. Ultimately in 1980 the IRS issued a private letter ruling to

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[46] Tex. Rev. Civ. Stat. art. 6132b, § 15 (1992). In 1997, the statute was amended to shield partners in Texas LLPs from contract liability as well. Tex. Rev. Civ. Stat. art. 6132b-3.08 (1998). The same full shield was carried over into subsequent amendments of the statute. The most recent is Tex. Business Organizations Code § 152.801 (eff. Jan 1, 2006).

[47] Susan Pace Hamill, *The Origins Behind the Limited Liability Company,* 59 Ohio St. L.J. 1459 (1998).

[48] *Id.* At 1463-66.

the Wyoming entrepreneurs that had begun the process, permitting them to create an LLC that would be taxed as a partnership to take over the business of their Panama Limitada.[49]

This began an eight-year struggle between the IRS and practitioners over whether or not to generally permit limited liability companies to be taxed as partnerships. As will be discussed further below, in 1988 the IRS capitulated and issued Revenue Ruling 88-76 that permitted properly structured LLCs to be taxed under Subchapter K or the Internal Revenue Code, the partnership tax provisions.[50] During these eight years, however, legal academics were uninvolved in debating this important question of tax and business policy. A search of the Legal Resource Index reveals only four articles on limited liability companies were published in United States legal periodicals before 1989. In 1981, a 3-page article was published in the Journal of Taxation.[51] In 1983, a student Comment was published in Florida State University Law Review[52], and a 3-page article was published in the Florida Bar Journal.[53] Finally in 1988, another student Comment was published in the Land and Water Law Review.[54]

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[49] *Id.* at 1466-67. See Private Ruling 8106082, 1980 PRL LEXIS 5766 (Nov. 18, 1980).

[50] Revenue Ruling 88-76, 1988-2 C.B. 360, discussed at ____ *infra.*

[51] Frank M. Burke, Jr. & John S. Sessions, *The Wyoming Limited Liability Company: An Alternative to Sub S and Limited Partnerships?,* 54 Jour. of Taxation 232 (1981). One of the authors, Frank M. Burke, was the lawyer who led the battle for the enactment of Wyoming's LLC statute. See Susan Pace Hammill, *supra.* note __, at 1463.

[52] Richard Johnson, *The Limited Liability Company Act (Florida),* 11 Fla. St. U. L. Rev. 387 (1983).

[53] Ernest A. Seemann, *The Florida Limited Liability Company: A New Form of Business Association,*57 Fla. Bar Jour. 536 (1983).

[54] Joseph P. Fonfara & Corey R. McCool, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership?,* 23 Land and Water L. Rev. 523 (1988).

Without assurance of partnership tax treatment, Wyoming's example did not immediately catch on. In the decade of the 1980's, only Florida followed suit.[55] Florida was apparently attempting to attract capital from Central and South America by furnishing an entity similar to the Limitada that was familiar to residents of countries in Latin America, many of whom had presumably made their way to Florida.[56] Even the issuance of Revenue Ruling 88-76 did not immediately provoke a widespread reaction. But in 1990, beginning with a statute enacted in Colorado, the landscape changed. Between 1990 and 1994, forty-five additional states adopted LLC statutes.[57] Professor Carol R. Goforth has published a detailed study of this fevered legislative activity and reached a rather clear conclusion:

> In virtually every state, those responsible for drafting and/or enacting LLC legislation cite motives which relate to attracting business and revenue to the state, or avoiding the loss of such business and revenues to other states. In many instances, the speed with which LLC legislation has been implemented is due at least in part to an express desire not to be left behind as neighboring or competing jurisdictions authorized the new business form. In still other states, especially those that were on the forefront of the trend, the express intent was to lead the way in attracting new business to the state by authorizing the new form of entity before other states.[58]

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[55] Susan Pace Hammill, *supra.* note __, at 1468-69.

[56] Richard Johnson, *supra.* note __, at 387.

[57] Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 Syracuse L. Rev. 1193, 1198-99 (1995).

[58] *Id.* at 1272.

In the 1990-1994 period, law professors became heavily involved in some of the drafting of LLC statutes. In Colorado, the state that began the legislative explosion, a law professor was one of the drafters of the legislation.[59] In many states, legislative activity was helped along by the American Bar Association. In 1990 the ABA began to draft a prototype LLC statute, developed a clearinghouse to aid state LLC drafting committees, and encouraged the Commissioners on Uniform State Laws to begin to draft a Uniform Limited Liability Company Act.[60] A law professor was Reporter for the ten-person drafting committee for the ABA's Prototype Limited Liability Company Act.[61] Law professors were also well represented on the committee that developed the Uniform Limited Liability Company Act[62]—a project that was completed in 1994[63] after nearly all the states had already adopted their first LLC statutes. Nevertheless, in the trenches in most jurisdictions, the state-specific drafting and the pressure for enactment of the state's limited liability company act was still largely the result of work by the practicing bar and bar associations.[64]

The LLC is a hybrid, embodying some elements of the partnership form and other elements that are normally aspects of the corporation. One of the most attractive features

[59] *Id.* at 1222 n. 137; J. R. Maxfield et al., *Colorado Enacts Limited Liability Company Legislation*, 19 Colo. Law. 1029 (1990).

[60] Susan Pace Hammill, *supra* note ___, at 1471-72.

[61] The Prototype Limited Liability Company Act along with a list of the drafters can be found in 1 Ribstein & Keatinge, LIMITED LIABILITY COMPANIES, Appendix B (2003). The professor acting as Reporter was Larry E. Ribstein, at the time Professor at George Mason University Law School.

[62] See 6A Unif. Laws Ann. 553 (2003) (listing committee members that prepared the Uniform Limited Liability Act).

[63] See Uniform Limited Liability Company Act (1996), Prefatory Note, 6A Unif. Laws Ann. 554, 555 (2003).

[64] Carol R. Goforth, *supra* note ___, at 1220-62.

of the LLC is the ability, through essentially contractual arrangements, to make the LLC more partnership-like or more corporate-like, depending on the needs of the owners. It can have a single manager or be managed by all its members. Its membership interests can be made freely transferable or their transfer can be limited. The LLC can be designed to dissolve upon death or retirement of any member, or it can be given an unlimited period of existence, unaffected by withdrawal of a member. State statutes sometimes differ as to which of these are imposed by default and which need special provisions in the LLC's operating agreement in order to be realized. But they can all be achieved.

Revenue Ruling 88-76 imposed significant limits on the type of LLCs that would be taxed as a partnership rather than a corporation. The rules for determining whether an entity would be taxed as a partnership or corporation that were in effect in 1988—the so-called Kintner Regulations[65]—were designed in response to attempts at an earlier time by professional service firms to be classified as corporations so that they could get certain tax-sheltered benefits for their employees which, particularly prior to 1982, were unavailable to partners.[66] So they favored treating entities as partnerships. The regulations identified four factors that distinguished a corporation from a partnership: limited liability, free transferability of ownership interests, centralized management, perpetual life. An entity was required to have three of these four to be classified as a

[65] See Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate,* 44 Cath. U. L. Rev. 437, 485 (1995). The Regulations were named after United States v. Kintner, 216 F.2d 418 (9th Cir., 1954).

[66] See Jerome M. Harris, *Parity in Employee Benefit Plans and Fringe Benefits For the Self-Employed After TEFRA and TRA '84,* 62 Taxes 529 (1984).

corporation. Conversely, so long as a business had at least two partnership-like characteristics, it would be taxed as a partnership.

LLCs, of course, had limited liability. They could also be manager-managed; or have freely transferable membership interests; or continue beyond the death or withdrawal of one or more of their members. But they could have only one of these additional corporate-like characteristics and still retain their partnership status for tax purposes. This meant that in the period immediately after 1988, business owners could not take full advantage of some of the flexibility of design that could make limited liability companies so attractive. It was only in 1997 with the promulgation by the IRS of the "Check-the-Box" rules that the full flexibility inherent in the LLC model could flower.[67] The Check-the-Box rules eliminated the tests used in the Kintner Regulations and permitted LLCs to freely choose to be taxed as a partnership, even if they had been structured to have all the characteristics that the Kintner Regulations ascribed to corporations. Alternatively, should a company desire it, an LLC can choose to be taxed as a corporation instead.

In the period immediately after 1988, lawyers were so obsessed with assuring that LLCs would get partnership tax treatment that some states adopted so-called "bullet proof" LLC statutes.[68] These did not permit an LLC to be formed with more than one of the additional corporate-like characteristics, just in case a lawyer did not otherwise know

[67] IRS Reg. §301.7701-2, §301.7701-3.

[68] Debra R. Cohen, *Citizenship of Limited Liability Companies for Diversity Jurisdiction,* 6 J. Small & Emerging Bus. L. 435, 447 (2002); Kenneth J. Kutchey, Richard P. Martel and Clark C. Johnson, *New IRS Regulations May Diminish Use Of Limited Liability Companies Formed Under the Michigan Statute,* 76 MI Bar Jnl. 340, 341-42 (1997); Walter C. Tuthill et. al., *Limited Liability Companies: Legal Aspects of Organization, Operation, and Dissolution,* 67 C.P.S. (BNA) A-2 to A-3 (1999).

the rules. After 1997, virtually all the states with bullet proof statutes changed them into statutes permitting greater flexibility in LLC structure.[69]

C. Why Are LLCs Really So Good?

The vast majority of business entities in the United States are small companies, owned by one or a handful of investors. It is for these kinds of businesses that the LLC is particularly well suited. It provides both tax and non-tax advantages over the alternative business forms.

The LLC can replace the sole proprietorship with a business that shields an individual's personal assets from his or her business creditors. Originally a number of states required an LLC to have at least two members. However in its 1997 Check the Box Regulations, the Internal Revenue Services permitted a single-person LLC to elect to be taxed as a sole proprietorship. That led states that previously were more restrictive to amend their LLC statutes to permit single-member LLCs.[70]

The LLC can replace the general partnership with a business that furnishes all of the advantages of the partnership, but also provides owners with limited liability. The general partnership has essentially disappeared as a "lawyered" business form. General partnerships that exist today are either holdovers from pre-LLC days or they are businesses entered into informally without legal advice that by default are subjected to the rules found in the Uniform Partnership Act.[71] The once-elaborately drafted

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[69] States that originally had bullet-proof statutes included Colorado, Michigan, Nebraska, Nevada, Michigan, Virginia, Wyoming. Debra R. Cohen, *supra* note___, at 447 n. 55.

[70] 1Ribstein & Keatinge, *supra* note __ , §1:3.

[71] Uniform Partnership Act (1997), §201(b) provides: "the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership."

partnership agreement has gone the way of the buggy whip and slide rule. It has been replaced by the LLC operating agreement.

1. Tax Advantages

The universally remarked upon tax advantage of the LLC over a traditional corporation is the elimination of the double taxation of profits. In a corporation taxed under the traditional rules of Internal Revenue Code Subchapter C, earnings are taxed to the corporation in the year when they are realized. When those earnings are distributed out to shareholders as dividends, they are taxed again to the shareholder, though since 2003 (and until 2009) usually at the same low rates that are applied to capital gains.[72] Subchapter K, the partnership tax provisions, impose only a single tax. Earnings and losses are passed through to the partner or LLC member in the year the business realizes them, whether those earnings are reinvested in the business or are distributed out to the business owners.[73]

Well before the development of the limited liability company, an alternative method of obtaining both limited liability and pass-through taxation was available. This was the Subchapter S corporation. A business formed under state law as a corporation can elect to be taxed for federal income tax purposes under the special rules of IRC Sections 1361- 1379. A Subchapter S election eliminates tax at the corporate level and taxes shareholders on corporate earnings in the year they are realized, just as is done for

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[72] IRC §1(h)(11), added by the Jobs and Growth Tax Relief Reconciliation Act of 2003, 117 Stat. 752 (2003).

[73] An exception to this exists for losses passed through to partners or LLC members who do not take an active role in the business. These rules were designed to prevent the use of partnership and Subchapter S business forms for abusive tax shelters. See Daniel N. Shaviro, 549-2nd T.M., *Passive Loss Rules* (BNA, 2000).

partnerships. However, this is the only partnership-like treatment given by Subchapter S. For other purposes, the corporate tax rules apply.

There are also some limiting requirements imposed by the Internal Revenue Code for a corporation to be eligible to elect Subchapter S treatment. Some, like the requirement that an S corporation may have no more than 75 shareholders[74], have little realistic impact on the small business. Prior to 1996, this number was 35[75]; however even at that level, most small businesses qualified. Two other limits, however, do make Subchapter S unattractive to some small businesses. First certain individuals and entities may not hold shares in S corporations: non-resident aliens, other corporations and certain trusts are the most important of these.[76] Secondly, S corporations are limited in the flexibility they have in raising capital. They may not issue preferred stock,[77] despite the fact that giving some equity investors a senior claim may be a useful technique to attract capital to a small business. LLCs are unconstrained in selecting who their investors will be or in creating flexible financing arrangements.

It is in areas of taxation beyond the pass-through of earnings and losses that the LLC may be a more important choice, for these tax advantages cannot be replicated by using the S corporation.[78] These differences span the life of the business, from initial investment to sharing in earnings, to liquidation.

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[74] I.R.C. §1361(b)(1)(A).

[75] See Samuel P. Starr, 730-2nd T.M., *S Corporations: Formation and Termination* A-15 (BNA, 2002).

[76] I.R.C. §1361(b)(1)(B),(C).

[77] I.R.C. §1361(b)(1)(D), (c)(4)-(5). The prohibition is on having "more than 1 class of stock" except common stock that differs only as to voting rights.

[78] See generally, Ronald J. Klein, Carlos A. Lacasa & Thomas O. Wells, *The New Limited Liability Company In Florida*, 73 Fla. Bar J. 42 (July/Aug. 1999); Susan Kalinka, *The Limited Liability Company*

If an investor acquires stock in an S corporation in exchange for property that has appreciated in value since the investor originally acquired it, the exchange of property for stock will be tax free only if the investor and other investors who transferred property at the same time end up owning at least 80% of the corporation's stock.[79] An investor can transfer appreciated property in exchange for an LLC membership interest without paying tax on the property's increased value, regardless of how small an interest in the LLC the investor and other property transferors end up with.[80]

In an S corporation, required to have one class of stock, all earnings are shared strictly in proportion to the number of shares held by each investor. One of the most important tax benefits of an LLC is the ability to create "special allocations" that pass through different sorts of income, losses or tax credits to different partners. For example, capital gains or depreciation deductions may be allocated disproportionately to one partner. In order to prevent tax evasion, there are complex limits on the extent to which special allocations will be recognized for tax purposes. Allocations that are not in accordance with the partner's interest in the partnership are valid only if they have "substantial economic effect"[81], a term that is elaborately defined in the regulations promulgated under §704 of the Internal Revenue Code.[82]

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and Subchapter S: Classification Issues Revisited, 60 Univ. Cincinnati L. Rev. 1083 (1992). Comparisons of partnership tax treatment with tax treatment of S corporations can be found throughout Alan Gunn, PARTNERSHIP INCOME TAXATION, Third Edition (1999).

[79] IRC §351.

[80] IRC §721.

[81] IRC §704.

[82] The "substantial economic effect" test is extremely complex. For an accessible discussion of it, see Alan Gunn, PARTNERSHIP INCOME TAXATION 55-76 (3d ed., 1999).

Losses, as well as gains, are passed through to the tax returns of individual investors in both S corporations and LLCs. However, losses can be deducted only up to an amount equal to the tax basis of the investor's stock or membership interest.[83] In an LLC, the investor's basis will be increased (permitting more losses to be deducted) in situations in which the investor's basis in S corporation stock would not be increased. In particular, when the LLC borrows money from a bank or other third party, this increases the LLC members' basis in their membership interests.[84] This seems an odd result. The rule makes sense in a general partnership; the partner becomes personally liable on the loan, so the loan is treated as an additional investment by the partner.[85] The same rationale is not available when owners are not personally liable on the loan; nevertheless, the same partnership rule applies to the LLC.[86]

If an LLC member withdraws and is paid for his or her membership interest through a distribution of appreciated property, rather than in cash, no tax is imposed.[87] Any gain the LLC member has realized on his or her membership interest is ultimately taxed when the property received is resold.[88] In an S corporation, if a shareholder's stock is repurchased by the corporation in exchange for appreciated property, not only may the shareholder be taxed on the gain realized on the sale of his or her stock,[89] but the

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[83] IRC §704(d), §1366(d).

[84] IRC §752.

[85] Alan Gunn, *supra.* note ___ at 13.

[86] Ribstein & Keatinge, *supra.* note ___, §17:9.

[87] IRC §731. But under IRC §736, some payments that are not in exchange for a member's LLC interest, but instead are guaranteed payments or a distributive share of income, are taxable.

[88] IRC §732(b).

[89] IRC §302.

corporation recognizes gain just as if it had sold the appreciated property and paid the shareholder cash. That gain is then passed through to all shareholders.[90]

Where a member in an LLC dies, sometimes heirs taking the LLC interest may be better off than if they had inherited stock in an S corporation. If the LLC has property whose fair value is higher than its depreciated value for tax purposes, the heirs may be able to adjust the basis attributable to them so that they can get more depreciation deductions on their taxes in the future. In an S corporation, only the basis of the stock would be affected; this would give the heir tax benefits only if the heir later sold the stock. It would not result in greater depreciation deductions if the heir continued to hold the stock.[91]

Despite these advantages, there are also some significant disadvantages to the LLC. The first is a problem for minority owners in both LLCs and S corporations. Many small businesses need to reinvest all of their profits in the business for a number of years. That fact does not prevent the investor from being taxed on his or her share the earnings of the LLC or S corporation. The investor must have a source of funds to pay those taxes. Minority investors may find themselves in a cash bind if they have not negotiated provisions obligating the business to distribute sufficient funds to enable them to pay the income taxes imposed on them.

Some small businesses are formed with the hope that if they are successful, they will be acquired in the future by a large publicly held company. When that kind of acquisition is made, it is usually desirable to structure it as a tax-free reorganization as

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[90] IRC §311, §1366. See Samuel P. Starr, *supra.* note ___ at A-105 to A-109.

[91] Alan Gunn, *supra* note [82] at 131-32.

defined in Section 368 of the Internal Revenue Code. A merger or acquisition of an LLC by a corporation does not qualify for tax-free reorganization treatment.[92] Therefore, an LLC about to be acquired may need to convert to corporate form. Sometimes companies that anticipate being acquired in the future by larger businesses are formed initially as corporations rather than LLCs in order to avoid the expense and delay of conversion later on.

Another potential disadvantage of the LLC involves not federal income tax, but federal social security (FICA) and self-employment taxes, including Medicare taxes. An employee and employer each pay half of the employee's required FICA taxes; a self-employed individual, including a partner or LLC member, pays the entire amount personally as self-employment tax. In 2004, the self-employment tax and combined social security tax rate was 15.3% on earnings up to $87,900, and 2.9% on all earnings above that.[93]

In the S corporation, the amount that a shareholder receives as a salary for working as a manager or officer in the business, and which is therefore subject to social security tax, is usually clear. The earnings that are a return on investment as a shareholder, and not for working as an officer or employee, are not subject to those taxes. In an LLC, the line between employment income and amounts received as a return on investment is less clear. The Internal Revenue Code, in its typically convoluted manner, focuses on whether the LLC member is in essence a limited partner. Amounts received for working in the business are subject to self-employment tax. Amounts received for the

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[92] See IRC §361(a).

[93] IRC §1401, §3101.

kind of passive investment that a limited partner makes are not.[94] In 1997, the IRS proposed a controversial set of regulations that would have helped LLC investors determine more clearly their self-employment tax liability.[95] Those regulations have never been adopted in final form, so that investors in an LLC walk on somewhat uncertain ground in determining the extent of their liability for self-employment tax.

All of this, finally, suggests another disadvantage of the LLC—the complexity of partnership tax rules when compared to tax rules governing corporations.

2. Business Advantages

Even if LLCs provided no tax advantages over corporations, they would still be extremely attractive for small businesses because of the informality and flexibility which they offer. In the typical small business, the owners seek legal advice in starting the business. Once they receive a fancy binder containing the business' organizational documents, their concern about legal formalities often disappears. The binder is placed in a file cabinet or desk drawer, and the owners move on to the real work of operating the business day to day. If the business was formed as a corporation, the lawyer reminds the owners that they need to make major decisions at board of directors meetings at which minutes are taken. The principals are instructed that each year they should hold a shareholders meeting and elect themselves directors again for the following year.[96]

For the business that is owned and managed by two or three individuals who work together day-to-day in the business, these formalities seem useless, if not absurd. It is

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[94] IRC §1402(a)(13).

[95] *Definition of Limited Partner for Self-Employment Tax Purposes*, 62 FR 1702 (Jan. 13, 1997). The proposal was so controversial that Congress at one point imposed a one-year moratorium on their adoption. Taxpayer Relief Act of 1997, §935, 111 Stat. 788, 882 .

[96] See generally, Franklin A. Gevurtz, CORPORATION LAW 186-95 (2000).

unlikely that they will remember that their discussion about changing suppliers might in fact be a directors' meeting. Unless the lawyer calls them each year, they almost certainly will forget to hold a formal shareholders meeting—after all they meet together every day at work. Even for a small business with one or two passive investors, these formalities are probably generally ignored.

It is possible to obtain most of the informalities offered by an LLC in a closely held corporation through properly drafted close corporation agreements.[97] However, in the LLC the informal operational provisions are the default rules and need not be specially drafted.

In a number of states, LLCs also offer investors greater flexibility in financing of the business. Some state corporate statutes prohibit, or at least limit, the extent to which the corporation may issue stock in exchange for future services or promissory notes.[98] LLC statutes universally impose no such limits. The promoter may take membership interests in the LLC in exchange for a promise to pay in the future or his or her agreement to operate the business, limited only by broad fiduciary duties and not by technical limits on the kind of consideration that can be used.[99]

The flexibility of LLCs also is the source of one of their disadvantages. LLC statutes are sometimes not comprehensive in creating default rules. More often than in corporate statutes, they fail to anticipate some of the gaps that may occur in poorly

[97] See e.g. M.B.C.A. §7.32.

[98] E.g. Mass. Gen. Laws Ch. 156, §15; Ohio Revised Code §1701.18. Until its amendment in 2004, Del. Code Ann., tit. 8, §152 precluded promissory notes and future services.

[99] See e.g. Del. Code Ann., tit.6, §18-501.

drafted governing documents.[100] The absence of some needed default rules means that lawyers must draft operating agreements more carefully than they draft corporate by-laws. If the lawyer has failed to provide for a particular contingency, there is less likelihood that LLC statutes will provide an adequate default rule to fill the gap.

III.

Explaining the Non-Adopting States

The data set out in Part I of this article indicates a wide disparity in the use of LLCs between states. In particular, in six states corporations still outnumber LLCs by at least 2-to-1. While discerning motivations of lawyers and their clients is a difficult task, there are special features in most of these states which tend to make the initial formation costs or ongoing operating costs of LLCs higher than for corporations.

New York

New York imposes an elaborate and costly publication requirement on LLCs that it does not impose on corporations. The LLC must publish a notice of its formation, with specified information in it, once per week for six weeks in two newspapers, approved by the county clerk in the county of its home office. At least one of the papers must be in the city or town where its office will be located.[101] Particularly for businesses headquartered in the largest metropolitan areas, this publication requirement can add significant costs to starting up a business. A similar requirement applies to foreign LLCs applying for a certificate of authority to do business in New York.[102]

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[100] For example, Delaware's LLC statute fails to set out the vote required to approve items when an LLC is structured to have a board of several managers, but fails to state the percentage of managers who must approve items. Del. Code Ann., tit.6, §18-402.

[101] NY CLS LLC §206.

[102] [102] NY CLS LLC §802(b).

In addition, New York's tax law imposes an annual filing fee on LLCs that is not imposed on corporations. The fee is imposed on any LLC that has income from New York sources. Before 2003, the fee was $50 per member, with a minimum of $325 and a maximum of $10,000. It did not apply to single-member LLCs. In 2003, a temporary increase in this fee for 2003 and 2004 was enacted. It rose to $100 per member with a minimum of $500 and a maximum of $25,000. Also a filing fee of $100 was imposed on single-member LLCs.[103]

California

California imposes a hefty annual franchise fee of $800 on every LLC, just as it does on corporations. But in addition, any LLC with income of over $250,000 per year must pay an annual statutory fee beginning at $900 and escalating to as much as $11,700 for an LLC with total annual income of $5 million or more.[104]

Florida

The comparatively few LLCs in Florida likely has a rather different explanation. Florida had a slow start. Even though Florida was the second state in the nation to enact an LLC statute, until 1998 there were significant state tax impediments to using an LLC. Until that year, Florida imposed its 5.5% corporate income tax on both LLCs and S corporations.[105] In addition, other aspects of Florida's LLC statute were unattractive. As

[103] NY CLS Tax §658(c)(3). See NY State Dept. of Taxation & Finance, Notice 03-29, *Important Notice Concerning Form IT-204-LL* (Oct. 2003), <www.tax.state.ny.us/pdf/Notices/N03_29.pdf> .

[104] Cal. Rev. & Tax Code §17941, §17942. Also see California Continuing Education of the Bar, FORMING AND OPERATING CALIFORNIA LIMITED LIABILITY COMPANIES §5.4B, §5.5.1 (2004).

[105] Ronald J. Klein, Carlos A. Lacasa & Thomas O. Wells, *The New Limited Liability Company In Florida,* 73 Fla. Bar J. 42 (July/Aug. 1999).

one Florida author has stated: “Although Florida was the second state to adopt an LLC statute …, that statute was the business form version of an Edsel. Nobody bought it.”[106]

The slow-start theory is supported by a comparison of 2003 data with that of 2002. While in both years corporations outnumbered LLCs by over 2:1, the growth rate of LLCs from 2002 to 2003 was vastly greater than the growth rate for corporations. The number of corporations increased only 18%; the number of LLCs grew by 61.5%.[107]

Illinois

Illinois charges $500 to file articles of organization for an LLC, while the fee for articles of incorporation is only $150. LLCs must file an annual report each year and pay a fee of $250. The comparable fee for corporations is only $75.[108] While these differentials are significant, one wonders whether they are large enough to account for the large disparity in the number of LLCs that are used in comparison to corporations. Another explanation suggested on the web site of one CPA in Illinois is that Illinois lawyers charge significantly higher fees to create LLCs than they do for corporations.[109]

North Dakota

Like the other states in which LLCs have not become dominant, North Dakota law reflects a significant differential in fees. The fee for filing articles of incorporation is

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[106] Baarbara Ann Banoff, *supra*. note [42] at 55 n.13.

[107] *IACA 2004 Annual Report of Jurisdictions,supra* note [__].

[108] 805 Ill. Consol. Stat 5/15.10; 805 Ill. Consol. Stat. 180/50-10. Apparently the legislature enacted two versions of §180/50-10 providing for LLC fees. The alternative version calls for $400 for filing articles and $200 for filing annual reports. The Secretary of State’s web site provides forms reflecting the higher of the two fee provisions.

[109] Taxperts Ltd. & Martin Freeman, CPA, *Starting A Business* (Nov. 2002), <www.taxpertsltd.com/starting_business.php> .

$30; the fee for filing LLC articles of organization is $125. The fee for filing a corporation's annual report is $25; for an LLC it is $50.[110]

There is also significant question about the accuracy of the 2003 data reported by North Dakota. In 2002, the reported total of all corporate and LLC filings in North Dakota was 3,239. For 2003, North Dakota reported a total of 29,274 filings, a nine-fold increase and more filings than neighboring Minnesota whose population is over seven times that of North Dakota's.[111] However, even the probably-more-accurate 2002 data indicated that over twice as many corporation as LLC filings were being made in the state.

South Dakota

South Dakota shows only minor fee differentials. Initial filing fees are essentially the same. For a corporation, annual report fees are $30. For an LLC, the fee is $50.[112]

A more likely explanation is that the data reported for South Dakota for 2003 are inaccurate. Taken from the IACA 2004 Annual Report of Jurisdictions, there are significant discrepancies between this data and that reported previously in the IACA 2003 Report. 2002 data reported in the 2003 Report indicated that slightly over 35% of filings were for LLCs-- 2,395 corporate filings and 1,300 LLC filings. In the 2004 IACA Report, the 2002 data that should have been the same as that reported the year before instead showed a total of 29,674 business filings instead of the 3,695 filings previously reported. It then reported 2003 filings that totaled 31,309. This number seems

[110] N.D. Century Code §10-19.1-147, §10-32-150.

[111] US Census Bureau, Geographic Comparison Tables for 2000 Census, available from <http://factfinder.census.gov>.

[112] S.D. Codified Laws §47-9-7; §47-34A-212.

implausible; it exceeds the number of filings for neighboring Minnesota that has over six times as many people as South Dakota.[113] A search of Public Records for South Dakota on LEXIS reveals more plausible figures: 2,862 corporations and 1,656 LLCs, with LLCs comprising 36.65% of total filings.

How Much Do Fee Differentials Matter?

While it is possible to point to fee differentials in the states in which LLCs have been least used, whether such differentials are sufficiently important to deter use of LLCs remains an open question. Some states in which LLCs have been most widely accepted have at least minor fee differentials. Wisconsin, for example, charges $170 to file LLC articles in paper and $130 to file them electronically. The fee for filing corporate articles is $100.[114] However, this differential seems modest in relation to those in most of the non-adopting states.

Many LLCs are extremely small businesses with limited capital. A few hundred dollars at the time of formation plus a few hundred dollars differential each year may be sufficient to affect the choice of entity. For many, perhaps an S corporation will seem "good enough", given this price differential.

IV.

Why Is Legal Education Mired In the Past In Teaching Business Organizations?

[113] US Census Bureau, Geographic Comparison Tables for 2000 Census, available from <http://factfinder.census.gov>.

[114] Wisconsin Department of Financial Institutions, *Limited Liability Company Filing Fees*, <www.wdfi.org/corporations/fees/ltd.asp> ; Wisconsin Department of Financial Institutions, *Domestic Corporation Filings & Fees*, <www.wdfi.org/corporations/fees/us.asp> (visited July 22, 2004).

While the teaching of law from casebooks has several interrelated justifications,[115] fifty years ago Columbia Law Professor Edwin W. Patterson described one of them in this way:

> Reported cases are frequently good evidence of contemporary American culture, of the way people do business normally …, of family arrangements, of police practices, etc. [116]

In furnishing students evidence of the dominance of LLCs in contemporary small business practice in America, the leading casebooks can only be counted as failures.

If we were designing materials to reflect that which students will actually encounter in law practice they would be significantly different from today's leading casebooks. If we were a law school curriculum committee, course offerings would look very different from those that prevail at American law schools. Advising a client about to embark upon a new small business, the lawyer will typically offer the client two choices—incorporate or form a limited liability company.

What of general partnerships? Today and in the future, new general partnerships will never be lawyered arrangements. They will be the inadvertent result of individuals entering business together informally. The Uniform Partnership Act default rules will then take hold of these informal arrangements, not because the entrepreneurs intelligently chose them, but because the law creates an ultimate set of default rules for those who leave their fate to chance.

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[115] See Edwin W. Patterson, *The Case Method In American Legal Education: Its Origins and Objectives*,4 Jour. Of Legal Education 1 (1951); Robert Stevens, LAW SCHOOL: LEGAL EDUCATION IN AMERICA FROM THE 1850S TO THE 1980S 51-72 (1983).

[116] Edwin W. Patterson, supra note __, at 21.

What of limited partnerships? They are still used occasionally. For example, in 2003, California reported 5,560 new domestic and foreign limited partnerships; Delaware reported 5,572; New York reported 1,357.[117] The drafters of the 2001 Uniform Limited Partnership Act identified the situations in which limited partnerships are most likely to be used in a world dominated by LLCs: "(i) sophisticated, manager-entrenched commercial deals whose participants commit for the long term, and (ii) estate planning arrangements (family limited partnerships)."[118]

Finally, what about limited liability partnerships (LLPs)? In states like New York which have "full shield" LLP statutes that protect against contract as well as tort liability, LLPs are used by law firms. The main advantage is that there need not be a total redrafting of organizational documents. The original partnership agreement—no doubt worked out through painful negotiations many years ago—can be retained. A vote of partners and an LLP filing is all that is needed.[119] Converting to an LLC with the attendant redrafting of basic documents would invite partners to raise difficult issues (like relative shares of profits) that most partners would rather leave lying where they are. So in New York in 2003—a state that has not widely adopted LLCs—480 new domestic and foreign LLPs filed. This number is, of course, miniscule in comparison to the 40,768 LLC filings.[120]

To these developments, we should add one more. Increasingly, a different set of governance rules are developing for publicly held corporations as opposed to small

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[117] *IACA 2004 Annual Report of Jurisdictions, supra.* note __.

[118] Uniform Limited Partnership Act (2001), Prefatory Note, 6A UNIF. LAWS ANN. 2 (2003).

[119] See Uniform Partnership Act (1997) §1001.

[120] *IACA 2004 Annual Report of Jurisdictions, supra.* note __.

businesses, whatever their legal form. The enactment of the Sarbanes-Oxley Act of 2002[121] removed any doubt about the emergence of two sets of rules—one for public companies and another for closely held ones. This statute created an elaborate set of new requirements, administered by the Securities and Exchange Commission, which apply only to companies that are publicly held or which are in the process of going public.[122]

How would the above reality be reflected in a law school curriculum and in law school casebooks that were truly designed to be good evidence of the way people normally do business in contemporary America? A law school might offer a course in Small Business Organizations in which equal time was spent covering LLCs and corporations. The LLC coverage would be preceded by a brief overview of agency and partnership law, with an emphasis on their applicability to unlawyered small business arrangements. However, most of the principles of partnership law would be taught as part of the coverage of LLCs. A separate course might then examine the special issues related to Publicly Held Corporations. Alternatively, separate courses, one in Corporations and another in Limited Liability Companies might be offered, with the latter including brief coverage of the applicability of partnership and agency law to informal business arrangements.

The wide disparity in LLC statutes, of course, makes teaching of LLCs in law schools more difficult. Which statute should a teacher use in a course? Standard statutory compilations published for law schools have chosen to include the Uniform

[121] PL 107-204, 116 Stat. 745 (2002).

[122] See 15 USC §7201(a)(7).

Limited Liability Company Act and Delaware's statute.[123] Those are reasonable choices since they represent two ends of the spectrum of statutes. The Uniform Act draws heavily on partnership law. Delaware's law draws more heavily on the corporate statute for inspiration.

There is little current empirical information on the business curriculum in American law schools. The existing studies are six to seven years old. Those studies suggest that law schools remain in denial so far as the LLC revolution is concerned. In May 1998, Prof. Robert Thompson obtained information from 71 teachers in 62 law schools about the coverage of their Business Associations courses. Almost all of the courses were 3 or 4 credit hours, i.e. 45 to 65 class hours over a semester. The average time devoted to partnerships was 4.18 hours. For closely held corporations, average coverage was 3.23 hours. The average time devoted to limited liability businesses of all kinds was 1.20 hours.[124]

If LLCs were not being covered in any significant way in the basic Business Associations course, were they being covered in a separate course? In the same study, 22 schools reported advanced courses in Agency and Partnership, while only 8 reported separate courses in Closely Held Businesses and 2 reported separate courses in Limited Liability Entities.[125] These numbers are reinforced by a survey conducted two years earlier obtaining information from 83 schools on new courses and seminars that had been

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[123] See Melvin Aron Eisenberg, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS STATUTES, RULES, MATERIALS, AND FORMS, 2004 EDITION; Jeffrey D. Bauman, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS STATUTES, RULES AND FORMS, 2004 EDITION.

[124] Robert B. Thompson, *The Basic Business Asssociations Course: An Empirical Study of Methods and Content*, 48 Jour. of Legal Education 438, 438-42 (1998).

[125] *Id.* at 446.

added to the curriculum between 1994 and 1997. While these schools together added 174 courses and seminars in the business and commercial area, only 4 were on limited liability companies.[126]

Anecdotal evidence suggests that the situation in law schools has changed little since these studies were conducted. The Association of American Law Schools sponsors numerous Sections which are interest groups made up of faculty from law schools around the country. For many years, it has had a Business Associations Section. In 2002, a new Section was created: “Agency, Partnership, LLCs and Unincorporated Associations”.[127] LLCs are there, among the list of many non-corporate forms. They are not recognized as sufficiently different from general partnerships, limited partnerships, LLPs and the like to deserve a separate Section devoted to them. They are not recognized as the dominant business form in the real world of business entities.

If courses covering LLCs were being offered in any appreciable numbers, law publishers who keep in close contact with law faculty, would likely have produced new casebooks. Instead, as the following review of recent casebooks indicates, LLCs continue to be treated as one of the several interesting permutations growing out of partnership law. Limited liability companies are not treated as one of the two dominant small business forms in 21st century America.

A Review of the Casebooks

Law students’ understanding of the world in which they will practice is shaped largely by the experience of their law teachers and the material in the casebooks they

[126] Deborah Jones Merritt & Jennifer Cihon, *New Course Offerings in the Upper-Level Curriculum: Report of an AALS Survey*, 47 Jour. of Legal Education 524, 540-41 (1997).

[127] Date of founding from e-mail from Prof. Gary Rosin, Chair of the Section in 2004.

read. The dominant pattern in hiring in American law schools makes it unlikely that most teachers of Business Associations have had significant recent experience in representing small businesses.[128] So the content of casebooks is often critical in shaping both teachers' and students' understanding of the business realities to which legal doctrines will apply. LLCs are slighted in the standard Business Associations and Corporations casebooks of the three leading publishers of law school teaching materials. Given the rapid rise of LLCs, I have limited this survey to casebooks with a copyright date of 2003 or 2004. It would be unfair to expect earlier casebooks to fully reflect the revolution. However, even these recently published casebooks have largely remained in denial about the most important change in small business practice in decades.

One significant indicator of the emphasis placed on various business forms in contemporary casebooks is the number of pages devoted to each business form. Another is the manner in which the development of LLCs is described in the casebook.

Klein, Ramseyer & Bainbridge

The 2003 Fifth Edition of Klein, Ramseyer & Bainbridge's casebook is titled *Business Associations: Cases and Materials on Agency, Partnerships and Corporations*. LLCs are not included in the title. It turns out, however, that there is an entire chapter devoted to them, plus a separate section on LLC mergers and a case on LLC interests as securities—all told, 47 pages in an 898 page casebook. The rest of the book covers other business forms: 91 pages are devoted to Agency; 104 pages are devoted to general partnerships; 12 pages at various points in the book are devoted to limited partnerships;

[128] See Harry T. Edwards, *The Growing Disjunction Between Legal Education and the Legal Profession*, 91 Mich. L. Rev. 34 (1992).

the rest of the book focuses on corporations. More importantly, the chapter on LLCs gives no hint of the growing importance of this business form. The one page introduction to three principal LLC cases and a Problem based on a fourth case informs the reader:

> The Limited Liability Company (LLC) is an alternative form of business organization that combines certain features of the corporate form with others more closely resembling general partnerships. ***
>
> The formation of an LLC, like the formation of a corporation, requires some paperwork and filings with a state agency. Some states impose fees and taxes (generally modest) on LLCs that are not imposed on partnerships.
>
> Another recent development is the Limited Liability Partnership (LLP).***[129]

It is only in the last paragraph of the introduction discussing LLPs that any mention is made of the extent to which the new non-corporate business forms have in fact been adopted in the business and legal world. The authors quote a 1995 article by Prof. Robert Hamilton stating that more than 1,200 law firms in Texas, virtually all the state's largest ones, became LLPs within one year after the LLP legislation was enacted.[130]

Hynes and Lowenstein

The 2003 Sixth Edition of Hynes and Lowenstein's casebook, *Agency, Partnership, and the LLC: The Law of Unincorporated Business Enterprises*, devotes more pages to LLCs than does any other standard casebook. While over half of the book is devoted to agency law, the last chapter, 71 pages in the 900 page book, focuses on

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[129] Klein, Ramseyer & Bainbridge, BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 287 (5th ed., 2003).

[130] *Id.*, quoting Robert W. Hamilton, *supra.* note [45].

Limited Liability Companies. In comparison, 260 pages are devoted to general partnerships (including LLPs) and 65 pages (almost as many as in the LLC chapter) are devoted to limited partnerships.

An introductory note to LLCs, slightly over two pages in length, is the book's sole attempt to explain the current importance of this business form. The following excerpts from suggest its flavor—one that does somewhat more than other books to alert students to the contemporary importance of LLCs:

> The limited liability company ("LLC") is a relatively new form of doing business.***
>
> The LLC is viewed by some investors as an improvement over the limited partnership because it allows for the exercise of managerial powers without the risk of personal liability for the debts of the business….***
>
> The LLC is viewed as an improvement of the general partnership because there is no personal liability for the debts of the business.***
>
> The LLC is an improvement over the corporation in some situations because it can be run more informally and the double taxation of operating in corporate form is avoided. It is regarded as an improvement over the Subchapter S corporation because its organization and operation are far less restricted.
>
> These advantages created a powerful incentive for states to pass enabling legislation allowing people to adopt this form of doing business once the Internal Revenue Service approved partnership tax status for a properly formed LLC.***
>
> The interest in the LLC is such that the field already has generated several substantial treatises and form books.***

> Almost all of the LLC enabling legislation was passed in the states only a few years ago. Thus the LLC is so new on the legal horizon that there is limited case authority available on it.***[131]

<u>*Hamilton and Macey*</u>

Hamilton and Macey's Eighth Edition of *Cases and Materials on Corporations Including Partnerships and Limited Liability Companies*, published in 2003, includes a 27 pages on Limited Liability Companies. Well over 1000 pages of the 1276-page casebook are devoted to corporations. General partnerships get almost five times the number of pages that LLCs do. Partnership cases and notes span 131 pages—including seven pages devoted to limited liability partnerships. Limited partnerships capture virtually the same space as do LLCs-- 26 pages.

In an introductory chapter devoted to all the various business forms, the editors describe the LLC a "a truly new business form" and tell their readers that "use of the LLC form has increased exponentially during the 1990s."[132] However, in a lengthy introduction in the chapter devoted to LLCs, the editors conclude:

> Despite numerous predictions that LLCs will quickly become the predominant business form for closely held businesses, data on the number of LLC formations indicate that growth has not been overwhelming.[133]

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[131] Hynes & Lowenstein, AGENCY, PARTNERSHIP, AND THE LLC: THE LAW OF UNINCORPORATED BUSINESS ENTERPRISES 829-31(6th ed., 2003).

[132] Hamilton & Macey, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 15 (8th ed., 2003).

[133] *Id.* at 205.

Supporting this statement, the editors cite Prof. John Lee's 2000 article[134] which, as discussed earlier, had analyzed data for 1995-1998, not the more recent data that leads to an exactly contrary conclusion.[135]

Choper, Coffe and Gilson

The 2004 Sixth Edition of Choper, Coffee & Gilson's *Cases and Materials on Corporations* is an 1188 page book that is overwhelmingly devoted to corporations. However, in a chapter on "Business Organization for the Smaller Enterprise", along with an 83-page discussion of close corporations the authors devote 12 pages to LLCs, 11 pages to limited partnerships, and just over one page to LLPs.[136] In a two-paragraph introduction to LLCs, the authors state that the LLC "has proved to be enormously successful".[137] However, a three-paragraph concluding note to the LLC section is captioned in bold type, "Why Are LLCs Not More Popular?".[138] The major citation to substantiate the assertion that LLCs have not supplanted other business forms is a 2001 law review article which used data for 1993 to1999, and focused mainly on whether LLCs had become more popular than LLPs.[139]

Ribstein and Letsou

Ribstein and Letsou's *Business Associations*, Fourth Edition, published in 2003. gives some of the briefest treatment to LLCs. Most of the 1004 page casebook is devoted

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[134] John W. Lee, *supra.* note [3].

[135] See text at note [3], *supra.*

[136] Choper, Coffee & Gilson, CASES AND MATERIALS ON CORPORATIONS , Ch. VII (2004).

[137] *Id.* at 832.

[138] *Id.* at 843-44.

[139] Larry E. Ribstein & Bruce H. Kobayashi, *supra.* note [5].

to corporations. Partnerships get approximately 52 pages. Limited partnerships get 10 pages. LLPs get 4 pages. LLCs get only seven!

In introducing LLCs, the authors say: "Over a half million LLCs filed returns in the 1999 tax year—significantly more than the number of limited partnerships, and over 30% of the total number of tax partnerships."[140]

Smith and Williams

A new Business Organizations casebook appeared in 2004—Smith and Williams, *Business Organizations, Cases, Problems, and Case Studies*. In their Preface, the authors discuss the movement in law schools from two separate courses--one in Corporations and another in Agency and Partnership—to a single course in Business Associations. They then comment:

> The most significant challenge … is that the law relating to business associations has been expanding at an unprecedented rate. Over the past two decades, new business associations (such as limited liability companies, limited liability partnerships, and variations of the business trust) have been developed and have gained widespread acceptance in the business world.[141]

Despite this insight, the book allocates only 23 of its 840 pages to LLCs. General partnerships get 74 pages; LLPs get 10; Limited Partnerships get 9. In introducing LLCs, the authors accurately inform readers: "The most important development in recent years in the area of business associations is the widespread acceptance of limited liability

[140] Ribstein & Letsou, BUSINESS ASSOCIATIONS 236 (4th ed., 2003).

[141] Smith & Williams, BUSINESS ORGANIZATIONS, CASES, PROBLEMS, AND CASE STUDIES xix (2004).

companies (LLCs) as an alternative entity for small businesses."[142] Despite this, the book gives 29 times the amount of space (669 pages) to Corporations as to LLCs.

Hazen and Markham

Limited liability Companies get 13 pages in Hazen and Markham's 1,277 page casebook, *Corporations and Other Business Enterprises Cases and Materials,* published in 2003. General partnerships get 25 pages; Limited Partnerships get 12; LLPs get 3 pages. Again the lion's share of coverage goes to Corporations. This casebook gives little hint of the contemporary importance of LLCs. In a Note following one of the cases, the authors merely remark: "Federal income tax advantages spurred the spread of LLC statutes."[143]

Allen and Kraakman

Allen and Kraakman's 2004 book, *Commentaries and Cases on the Law of Business Organizations* devotes only three of the book's 654 pages to LLCs. Despite its 2003 publication date, the book relies on 1996 and 1997 data to conclude that "recent trends suggest the benefits of LLCs are gaining widespread acceptance (even as corporations remain the dominant form of legal entity)".[144] The editors stress that the LLC has largely replaced the limited partnership in oil and gas ventures, real estate investment and active investment companies.[145] Nevertheless, limited partnerships also

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[142] *Id.* at 147.

[143] Hazen & Markham, CORPORATIONS AND OTHER BUSINESS ENTERPRISES CASES AND MATERIALS 82 (Standard Edition, 2003)

[144] Allen & Kraakman, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 78 (2003).

[145] *Id.* at 73.

get 3 pages. General partnerships command 33 pages. In this generally pared-down book, Corporations are covered in 573 pages.

Bauman Weiss and Palmiter

Bauman, Weiss and Palmiter's 2003 casebook, *Corporations Law and Policy Materials and Problems, Fifth Edition* primarily covers Corporations. However, scattered throughout a 17 page discussion of choice of organizational form is information on LLCs along with other business forms. After briefly describing the advantages of an LLC, the authors comment: "This has led some commentators to speculate that the advent of the LLC may spell the death knell of the general partnership form of business organization."[146] They make no predictions about the impact of LLCs on corporations.

Interpreting the Results

What are we to make of this departure from business world realities reflected in Business Organization casebooks? There are a number of possible explanations—but none are particularly satisfactory.

Given the comments in a number of the books, many of the authors seem to have been unaware of the full extent to which by 2002 LLCs had intruded on the landscape. The formal data showing the sea change in LLC adoptions was not fully available, and certainly had not been commented upon in the academic literature, at the time these casebooks were being prepared. The trend was obvious to many practicing lawyers, even without the formal data. However, many of the authors of the leading Business Associations casebooks live in states in which LLCs have been the least popular. Of the 21 authors of the casebooks reviewed, twelve of them teach at law schools in California,

[146] Bauman, Weiss & Palmiter, CORPORATIONS LAW AND POLICY MATERIALS AND PROBLEMS 162 (5th ed., 2003).

New York, Massachusetts, Illinois and Texas—all states in which 40% or fewer of new businesses are LLCs.[147] It is likely that these authors do not normally interact with practicing lawyers who prefer LLCs as a business form.

The market for Business Organizations casebooks is also largest in states in which LLCs have been least popular. Law schools in California, Florida, New York, Illinois, Massachusetts, and Texas enroll very large numbers of students. California alone boasts 52 different law schools, and New York has 15.[148]

There are other reasons as well that probably contribute to the skimpy coverage of LLCs in these standard Business Organization casebooks. Many of these casebooks are in their third, fourth, fifth, or even eighth, editions. To turn an existing casebook into a model that reflects the reality of today's business world would involve far more rewriting and restructuring than is normal for merely a new edition. Indeed it would involve creating an entirely different book. Three constituencies are resistant to this kind of wholesale restructuring—the authors, law school faculty who currently teach from the book, and publishers. For authors, the amount of work involved is immense. For current users of the casebook, a new edition that departs radically from the old means that entirely new class notes must be prepared. One might consider switching to a totally different book at that point. For publishers, the possibility of losing current users by substituting an unknown new product for a profitable and well-accepted existing one creates an unattractive business risk.

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[147] California- William A. Klein, Stephen M. Bainbridge, Jesse H. Choper, Ronald J. Gilson. Illinois- Cynthia A. Williams, Larry E. Ribstein. Massachusetts- Reinier Kraakman, J. Mark Ramseyer. New York-William T. Allen, Jonathan R. Macey, John C. Coffee. Texas- Robert W. Hamilton.

[148] State Bar of California, Bar Admissions, <www.calbar.org/admissions/2admsch.htm>; FindLaw for Students, <stu.findlaw.com/schools/usaschools/newyork.html> .

Yet among the casebooks surveyed above are three that appeared in their premier editions in 2003 or 2004. Why are they not better reflections of the real world? With a plethora of books devoted primarily to corporations, why is at least one of the new titles not a book devoted to LLCs? First, to the extent that an author proposes a casebook designed for a separate course in LLCs, publishers respond by pointing out that few, if any, such courses exist, so there will be no market for the book. There is, of course, a "Catch 22" element to this. Law school faculty who may be considering offering a separate LLC course are often deterred because no good teaching materials are available for such a course.

From the publisher's perspective, little is broken, so no fix is needed. The only persons being injured by the lack of casebooks that reflect the real world are law students—and they will not realize this until they graduate and enter law practice. Then this lack will just be one more reason to complain about the "theory" taught in law school that fails to prepare graduates for the actual practice of law.[149] Most lawyers relish the opportunity to take these kinds of jabs at professors who formerly held such power over them anyway.

Casebook publishing has become increasingly concentrated in recent years. All but one of the formerly smaller independent publishers have been acquired by the "big three": Thompson/West, Aspen Publishers or Lexis-Nexis. The one remaining small independent casebook publisher is Carolina Academic Press. Publishers are driven by the potential sales for a new casebook. Each of the publishers already has a full stable of established titles in Business Associations. A new title is as likely to eat into its

[149] See Harry T. Edwards, *supra.* note [128].

publishers other offerings as it is to challenge a competitor's titles. New titles in a crowded field are probably most welcome by publishers when they involve co-authors each of whom can offer large classes as a guaranteed market.

We cannot, however, blame only the publishers. Few authors seem to have seriously considered giving extensive treatment to LLCs. There appear to be two rationalizations for this.

First, they argue that there is not yet enough case law on LLCs to assemble a casebook on them.[150] However this is demonstrably false. Cases on LLCs have begun appearing regularly. Yet academics apparently remain unaware of many of them. One reason for this is, again, the complicity of law publishers. The West Digest system mixes LLC cases indiscriminately in with Corporations cases in its widely-used Key Number System. This hides the true growth of case law in this area. In 2004, West began to take steps to remedy this. West has included a new special Key Number (241E) for LLCs in its electronic Key Cite system in Westlaw. However, this new category is not yet reflected in the paper version of its digests, and as of July 2004 only a handful of cases have been transferred online to the new key number.

There are, however, other ways to discover new LLC cases. Full text searches in LEXIS and Westlaw turn them up. Admittedly, there are not as many cases as in the corporate area, but there are significant numbers of LLC cases. Modern casebooks in Business Associations set out comparatively few principal cases. Certainly the available cases, along with problems and notes, give sufficient material to produce a useful casebook.

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[150] See the quotation from the Hynes & Lownestein casebook accompanying note [131] *supra.*

When faced with the facts that the raw material is there, authors often resort to another explanation. Since LLCs are a cross between partnerships and corporations, students can easily understand LLCs on their own once they learn partnership and corporate law. There is no need to explicitly cover LLCs in a Business Associations course. Again, there seems little of substance to this argument. At a time when partnership courses were centered on the bare bones 1914 Uniform Partnership Act, one might argue that a partnership course of necessity would deal in broad principles of common business ownership that could easily be transferred between business forms. However today when the majority of states have adopted the complex and technical 1997 Uniform Partnership Act, partnership law courses are likely to be more narrowly focused if they are to be useful. The transferability of this type of partnership material to the creation and operation of LLCs will be less obvious.

If teachers can rely on students to understand the transferability of learning to related business forms, a different argument would seem more persuasive. Given the relative use of the various business forms in today's business practice, it would be more logical to argue that at least half of the basic Business Associations course should be devoted to LLCs, and students can easily extrapolate from this the principles needed to deal with the residual group of partnerships that end up being formed by default.

There is yet one additional factor driving the over-emphasis on partnership law and the ignoring of LLCs in basic Business Associations courses. This is the Bar Exam. Most faculty protest loudly when it is suggested that their course coverage should encompass the items on which bar examiners will test students. Yet, for the most part, law schools do envision one of the purposes of a basic core curriculum as being preparation of their graduates to pass a bar exam. Bar examiners do not appear to have changed the focus of their testing to give appropriate emphasis to limited liability companies.

The empirical data on material actually tested on recent bar exams is difficult to come by. Business Associations is not tested on the multiple choice Multi- State Bar Exam, used as a portion of the state bar exam by 48 states and the District of Columbia. Business Organizations topics are part of the Multistate Essay Exam (MEE) which is used by 14 states and the District of Columbia along with the MBE.[151] Other states write their own Business Organizations questions. The best sources of information on bar examiners' outlooks are the Outlines of subjects to be covered on the bar which most states issue.

The MEE outline of topics potentially covered on the bar exam embraces the importance of LLCs. The outline gives equal coverage to corporations and LLCs. However, when we shift focus to the essay portion of bar exams in other states, quite a different picture appears. On the theory that LLCs would most likely be covered on the bar exam in states in which LLCs are most widely used, I reviewed the rules covering bar exam subjects in the 11 states which in 2003 reported that LLC filings constituted over 60% of their business filings. In only one of those states, New Hampshire, were LLCs given equal billing with agency, partnerships and corporations.[152] Some of the other states indicate that they test on "business organizations" or "business entities", but do not

[151] See *Multistate Examination Use*, <www.ncbex.org/tests.htm>; *MEE Subject Matter Outlines*, <www.ncbex.org/tests/mee/specs.htm>.

[152] NH Supreme Court, *Information About the NH Bar Examination*, Sec. V.C., <www.courts.state.nh.us/nhbar/infobarexam.htm>.

specifically mention LLCs. A number of those states specifically mention agency, partnerships and corporations as areas of coverage, along with the general reference to business organizations.[153]

Delaware, Michigan, Missouri and New Jersey do not even leave open the option of testing on LLCs. They specify agency, partnerships and corporations as topics covered, but do not even include a general reference to other business forms.[154] Wisconsin admits graduates of in-state law schools without an exam through its diploma privilege. To qualify, students must take at least 60 semester hours from a list of electives. These same subjects are tested in the bar exam for applicants who do not qualify for the diploma privilege. The list includes courses in partnerships and corporations, but makes no reference to LLCs.[155]

If states in which LLCs have become popular seldom include LLCs on their bar exams, we would expect no greater coverage in states in which LLCs are not as widely

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[153] **Arizona**: "corporations, partnerships, and other business organizations", Supreme Court of Arizona, *Frequently Asked Questions, Examination Information*, <www.supreme.state.az.us/admis/examinfo.htm>; **Connecticut**: ""Business entities (including corporations, partnerships and sole proprietorships), Conn. Bar Examining Committee Regulations (2003 Edition), Art. V-4, <www.jud.state.ct.us/CBEC/BarExCom2.htm>; **Louisiana**: "Business Entities and Negotiable Instruments", Rules of the Supreme Court of Louisiana, Admission Rules, Art. XIV, Sec. 7, <www.lascba.org/admission_rules.asp> ; **Ohio**: "Business Associations (including Agency, Partnerships and Corporations", Ohio rules of Court Rules for the Government of the Bar of Ohio, Rule I, Sec. 5(A)(3)(b), >www.sconet.state.oh.us/rules/govbar/default.asp>, though in a longer *Outline of Subjects Tested on Essay Portion of Ohio Bar Examination, Nov. 2002,* in the Partnerships Outline, a section captioned "Special Kinds of Partnerships and Related Unincorporated Organizations" lists LLCs among 8 kinds of special business organizations that could be tested; **Oregon**: "business organizations, corporations and partnerships", Oregon Supreme Court Rules Regulating Admission to Law Practice in Oregon, Rule 5.15 (April 13, 2004), <www.osbar.org/_docs/rulesregs/admissions.pdf> .

[154] Del. Supreme Court Board of Bar Examiners Rules, Rule 12, <courts.state.de.us/bbe/docs/bberules.pdf>; Mich. Rules for the Board of Law Examiners (Amendments through May 1, 2000), Rule 3(A)(2), <www.michbar.org/professional/pdfs/C-RulesBLE.pdf> ; Mo. Board of Law Examiners, Regulations under Rule 8.08, available from <www.courts.mo.gov/sup/index.nsf>; N.J. Board of Bar Examiners, "New Jersey Essay Questions", <www.njbarexams.org/barbook/aic4.htm>.

[155] Wisconsin Supreme Court Rules, SCR 40.03(a), SCR 40.04(b)(2), <www.wicourts.gov/html/rules/CHAP40.htm > .

used. A sampling of bar exam coverage in those states confirms that conclusion. New York tests on “Business Relationships”, without further specification.[156] California tests on “Corporations”, but not on LLCs.[157]

V.

<u>The Need for Scholarly Analysis and Law Reform: The Social Costs of Academic Neglect</u>

As we have seen, for the most part LLC statutes were drafted quickly by small groups of practitioners in each state. They may have had the ABA Prototype Limited Liability Company Act and statutes from other states to use as models. But often states seem to have borrowed heavily from their own partnership and corporate statutes in their drafting of LLC laws. This hurried and competitive drafting has resulted in a wide disparity between statutes. Indeed it was this “dazzling array of diversity” that led to the drafting of the Uniform Limited Liability Company Act.[158] However only eight states have adopted the ULLCA.[159]

Existing LLC statutes are far from perfect. In all areas of law, statutory provisions undergo continual scrutiny and updating. In “technical” areas, like the law of business organizations, state legislatures often rely on outside experts to initiate law reform. The diversity in LLC statutes makes law reform more difficult. Unlike the

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[156] NY State Board of Bar Examiners, *The Bar Examination,* <www.nybarexam.htm>.

[157] State Bar of California, *Scope of the California Bar Examination: General Bar Examination and Attorneys’ Examination,* <www.calbar.ca.gov/calbar/pdfs/admissions/ex1000900.pdf> .

[158] Uniform Limited Liability Company Act (1996), Prefatory Note, 6A Unif. Laws Annotated 554 (2003).

[159] Alaabama, Hawaii, Illinois, Montana, South Carolina, South Dakota, Vermont and West Virginia. The U.S. Virgin Islands has also adopted it. Uniform Law Commissioners, *A Few Facts About The Uniform Limited Liability Company Act”,* <www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ullca.asp> .

corporate area, where reform is typically initiated by Delaware or by the drafters of the Model Business Corporation Act[160], in the LLC area no recognized lead group has emerged to spearhead technical law reform. It is voids such as this that cry out for the work of academic researchers. As we have seen, however, academics have often ignored the LLC.

Because of the wide variations in provisions of different LLC statutes, there is often a need for state-specific reforms in the law. Even though it should be, this task is not well suited to the typical research agenda of today's law school faculty members. Law schools strive for national recognition;[161] state-specific research suggests that one's law school is merely a local lawyer-training facility. That is inconsistent with attempting to move up in the "pecking order" of law schools. It is also inconsistent with law schools' decades-old efforts to prove that they are part of a university engaged in broad-based research, and are not merely a "trade school".[162] Another impediment to law reform suggestions by academics is the fact that it is more difficult for faculty to find publication outlets for state-specific research. Generally only law reviews published by schools in the state involved are willing to consider articles relating to a single state's law. In many cases this limits a faculty member to a handful of journals, all of whom have third year law students, rather than peer reviewers, making decisions on which

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[160] The MBCA is drafted by the Committee on Corporate Laws of the American Bar Association Section of Business Law. 1 Model Business Corporation Act Annotated, Introduction at xxviii (3rd ed., 2002).

[161] See Cynthia Cotts, *Deans and Watchdogs Flunk U.S. News Law School Rankings*, Natl. L. Jour., March 2, 1998, Pg. A13; Janet L. Conley, *Success Fosters Ambition at GSU*, Fulton County Daily Report, Sept. 19, 2002.

[162] See Robert Stevens, *supra.* note [115] at 52-53; Martin Lyon Levine, LEGAL EDUCATION 51-94 (1993).

articles to publish.[163] Sometimes it effectively limits a faculty author to publishing in his or her own school's law review, and that is often looked down upon by tenure and promotion committees.

If the world were different and academics could focus on research to improve the nearly dominant business form in use for small businesses, what would their research agendas look like? Many state statutes display significant weaknesses in rather basic areas. Practitioner-drafters, apparently focusing on the needs of their universe of clients, sometimes failed to foresee the wider group of businesses that would ultimately choose the LLC form. Some of the drafters, coming from a corporate practice, inserted detailed provisions from corporate statutes relating to matters of less concern to LLCs,[164] while ignoring fundamental issues that small businesses adopting the LLC form might often encounter. Some drafters, including those drafting the Uniform Act, analogized LLCs too closely to partnerships, failing to foresee some of the subtle differences between the two forms.

At least four areas would suggest themselves as candidates for an initial attempt at law reform.

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[163] See Bernard J. Hibbitts, Last Writes? *Re-Assessing The Law Review In The Age Of Cyberspace*, 30 Akron L. Rev. 175, 177 (1996); Michael L. Closen & Robert J. Dzielak, *The History and Influence of the Law Review Institution*, 30 Akron L. Rev. 15, 43-47 (1996).

[164] For example, some LLC statutes include elaborate indemnification provisions based on provisions designed primarily for publicly held corporations that are contained in corporate statutes. See Alaska Statutes §10.50.148; 31 Maine Rev. Stats. §654; Miss. Code Ann. §79-29-110; Ohio Rev. Code §1705.32. More thoughtfully drafted statutes include indemnification provisions more suited for smaller businesses, e.g. 6 Del. Code §18-108.

A. Conceptualizing the Operating Agreement

For an LLC, the operating agreement is the key document that governs relations between members of the LLC.[165] The operating agreement resembles the partnership agreement in a general partnership; it also resembles corporate by-laws. Ultimately however it is different from both of these.

In many cases, LLCs—particularly manager-managed LLCs—replace the S corporation as the business form preferred by entrepreneurs and their lawyers. Promoters therefore often envision the corporate model of bringing in a few outside investors. The LLC will be formed by those who originally conceive it, its organizational documents will be executed, and it may be that only somewhat later will a few angel investors or venture capitalists will be sought out. For the investor purchasing corporate stock later than the promoters do, it is clear that the corporate by-laws adopted by the promoters are binding. No such automatic application of the operating agreement in an LLC occurs merely because an investor acquires a membership interest in the business.

Aware of the fact that LLCs are sometimes run informally, most LLC statutes provide that the operating agreement is any agreement of the LLC members relating to the affairs of the LLC, whether the agreement is written or oral.[166] What happens if a written operating agreement has been prepared, an investor is listed in it as being a member, but the investor fails to sign the operating agreement? Is it binding on the member if all the other members have signed it? Do we need to determine whether the

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[165] Some states call this key document by another name. Delaware, for example, refers to it at the "limited liability company agreement". 6 Del. Code §18-101(7).

[166] See e.g. Unif. Limited Liability Company Act (1996) §103; 6 Del. Code §18-101(7); Ohio Rev. Code §1705.01(J); Cal. Corporations Code §17001(ab). New York's statute requires that the operating agreement be in writing, NY Limited liability Company Law §417.

member has informally agreed to the document that his or her fellow-members have actually signed? What if no one has signed the document, but all investors have informally acquiesced to a draft of the operating agreement?[167]

LLC statutes would be more useful if they gave clearer guidance on how to resolve this kind of question. They might, for example, be amended to provide that if an individual advances funds in exchange for membership interests that are validly issued to the investor, even if the investor has not signed the LLC's formal operating agreement a presumption will arise that the individual has accepted the operating agreement that has been signed by the other members. Here is an early topic for the agenda of LLC law reformers.

B. Basic Issues of Authority

Limited Liability Companies may be member-managed or manager-managed, depending upon the election made in the operating agreement or articles of organization. Generally if the organizational documents are silent on the matter, the default rule results in the LLC being member-managed.[168] A member or manager who has actual authority to conduct the LLC's affairs clearly binds the LLC when the individual enters a transaction on behalf of the company. The more difficult question arises, however, when an individual without actual authority purports to enter a transaction on behalf of the LLC. When will the LLC be bound?

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[167] Cf. Child Care of Irvine, L.L.C. v. Facchina, 1998 Del. Ch. LEXIS 114 (July 15, 1998) (dispute over which document, if any, was intended by the members to be the LLC agreement).

[168] See e.g. Unif. Limited Liability Company Act (1996) §101; 6 Del. Code §18-402; Ohio Rev. Code §1705.24; Cal. Corporations Code §17150; NY Limited liability Company Law §401.

At first blush, this appears to present a run-of-the-mill question of apparent authority.[169] However, upon closer examination, it becomes clear that the peculiar language in various LLC statutes can make the issue of apparent authority in an LLC significantly more complicated that the analogous question in the context of partnership or corporate law. Many statutes have included provisions that appear to confuse the usual concepts of actual and apparent authority. Beyond this, the special problem of whether an LLC *member* can have apparent authority to act on behalf of a *manager-managed* LLC creates special complications not present in other business forms.

The Uniform Limited Liability Company Act has largely avoided the confusion present in a number of other LLC statutes. Section 301 of the Uniform Act makes it clear that if a member or manager has actual authority, the person's act binds the LLC. If a member or manager does not have actual authority, the person's act does not bind the company when a third person had notice or knowledge of the lack of authority. In dealings with a person who does not have such notice or knowledge, an act by the *member* binds the LLC if the LLC is member-managed and the member's act is for apparently carrying on in the ordinary course the company's business or business of the kind carried on by the company. If the LLC is manager-managed, a *manager's* act in dealing with a person who has no notice or knowledge of the manager's lack of authority binds if it is apparently for carrying on in the ordinary course the company's business or business of the kind carried on by the company. A member in a manager-managed LLC does not have apparent authority solely by reason of being a member, just as a

[169] See Restatement (Third) of Agency §2.03 (Tentative Draft No. 1, 2000).

shareholder in a corporation lacks apparent authority to bind the corporation solely because the individual is a shareholder.[170]

The special problem with this distinction in the LLC is that in some states third parties have no way of knowing whether an LLC is or is not manager-managed. Nothing about the name of an LLC hints at whether it is member or manager managed. In a number of states, in order to determine this an individual must examine the LLC's operating agreement. However, under virtually all LLC statutes, operating agreements are not a matter of public record. Only the brief articles of organization, not the longer operating agreement, are filed with the state secretary of state.[171] A third party can demand a copy of the operating agreement before dealing with the LLC; however few individuals do so in anything other than major transactions.

This problem is avoided in most states. They require that if the LLC is to be manager managed, this must be specified in the filed articles of organization.[172] In those states, third parties are at least on constructive notice through a document that is publicly available that they are dealing with a manager-managed LLC and that they cannot assume that members would normally act for the company. A number of other states, however, relegate the choice of management type to the non-public operating agreement.

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[170] Unif. Limited Liability Act (1996) §301(b)(1).

[171] Unif. Limited Liability Company Act (1996) §202.

[172] E.g. Uniform Limited Liability Company Act §203; Ariz. Rev. Stat. §29-632; Ark. Code Ann. §4-32-202; Cal. Corp. Code §17151; Conn. Gen. Stat. §34-121; Idaho Code §53-608; 805 Ill. Compiled Stats. Ann. §180/5-5; Burns Ind. Code Ann §23-18-2-4; Ky. Revised Stat. §275.025; 31 Maine Rev. Stat. §622; Mich. Comp. Laws Serv. §450.4203; Mont. Code Ann. §35-8-202; Miss. Code Ann. §79-29-201: N.H. Rev. Stat. Ann. §304-C:12; 15 Pa. Consol. Stat. §8913; S.D. Codified Laws §47-34-12; Texas Bus. Org. Code §101.251; Rev. Code Wash. (ARCW) §25.15.070; Wyo. Stat. §17-15-107.

They permit, but do not require, this information to be in the articles of organization.[173] Here then is another agenda item for law reformers. What are the reasonable expectations of third parties about the power of LLC members to bind the business in transactions on behalf of the LLC?

A few LLC statutes create another kind of confusion about authority. Concern about the plight of those searching title when a conveyance by an LLC is in the chain of title has led to provisions to give some comfort to property lawyers. A well-drafted version can be found in the Uniform Act:

> Unless the articles of organization limit their authority, any member of a member-managed company or manager of a manager-managed company may sign and deliver any instrument transferring or affecting the company's interest in real property. The instrument is conclusive in favor of a person who gives value without knowledge of the lack of authority of the person signing and delivering the instrument.[174]

Some states, however, have been less careful in drafting provisions to give comfort to those searching title. They merely provide that instruments and documents conveying or mortgaging property[175] are valid and binding on the LLC if they are executed by one or more members in a member-managed LLC or by one or more

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[173] E.g. 6 Del. Code §18-201; Fla. Stat. §608.407; Off. Code of Ga. Ann. §14-11-204; Iowa Code §409A.303; La. Rev. Stat. §12:1305; N.D. Cent. Code §10-32-07; N.J. Stat. §42:2B-11; N.Y. Consol. L. Serv., LLC §203; Ohio Rev. Code §1705.04; Va. Code Ann. §13.1-1011.

[174] Unif. Limited Liability Company Act (1996) §301(c).

[175] Generally these provisions are not limited to *real* property.

managers in a manager-managed company.[176] Read literally, the statutes in these states validate an unauthorized conveyance or mortgage, even where the transferee knew of the lack of authority, so long as the proper signature appears on the relevant documents.

Prior to 2001, the Utah LLC statute contained one of these poorly drafted provisions on transfer of property.[177] In *Taghipour v. Jerez*[178] the court was faced with the question of whether this apparent validation of all properly-executed conveyances trumps the provisions in the LLC statute regarding actual authority of managers. While in this case, the third party was a bona fide purchaser and was therefore rightly protected, the court's rationale in upholding the mortgage of LLC property did not limit itself to the protection of BFPs. Instead the court applied the maxim of statutory construction, "when two statutory provisions conflict in their operation, the provision more specific in application governs over the more general provisions."[179] That approach would call for a literal application of the statutory language, even when the third party knew that the real estate transaction had not been properly authorized.

Whatever the mischief of these provisions that limit themselves to conveyances and mortgages of property, even greater confusion is created by provisions in Delaware's Limited Liability Company Act §18-402. The section begins by providing that an LLC can be member-managed, in which case decisions are made by those owning a majority

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[176] See e.g. Ohio Revised Code §1705.35; R.I. Gen. Laws §7-16-68; S.D. Codified Laws §47-34-20; Wyo. Stat. §17-15-118.

[177] Utah Code §8-2b-127(2), repealed Laws 2001, ch. 260, §196.

[178] 52 P.3d 1252 (Sup. Ct. UT, 2002).

[179] 52 P.3d at 1255.

of the interests in profits. Alternatively the LLC can elect to be manager-managed in whatever way the LLC agreement specifies. But then the section states:

> Unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company.

Does this mean that a member that has been outvoted by fellow members still binds the LLC when the member enters a contract with a third party that knows of the opposition of the majority? Does the initial phrase in the sentence mean that if the operating agreement deprives a member or manager of actual authority to carry out a particular transaction, the doctrine of apparent authority will not apply either to protect a third party who has been misled? The Delaware courts do not appear to have yet interpreted this section.

Law reformers need to resurrect in LLC statutes the simple distinctions between actual authority and apparent authority that originate in Agency law[180] in order to avoid the injustice threatened by poorly drafted provisions on the power of members and managers to bind the LLC.

C. Fiduciary Duties

Agency, partnership and corporate law have each developed their own notion of the duties of care and loyalty owed by those who jointly own, or who are employed in, a business. The duties differ somewhat in each of these business forms.[181] How do the fiduciary duties of members and managers of an LLC compare with those of co-owners or managers in other business entities?

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[180] Restatement (Third) of Agency, §2.01- §2.03 (T.D. No. 1, 2000).

[181] See Paula J. Dalley, *To Whom It May Concern: Fiduciary Duties and Business Associations*, 26 Del. J. Corp. L. 515 (2001); Eric Talley, *Team Production in Business Organizations: Taking the "I" Out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties*, 24 Iowa J. Corp. L. 1001 (1999)

Let us begin with the conventional narrative. In small, closely-held businesses, associates work together closely and their relationship requires the highest level of trust and confidence. The strongest version of duties should prevail in the small partnership-like business arrangement. Those duties are most often described by quoting Chief Justice Cardozo's New York Court of Appeals opinion in *Meinhard v. Salmon*:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of finest loyalty. 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. It will not consciously be lowered by any judgment of this court.[182]

The conventional narrative continues: the small closely-held corporation is really a partnership that happens to have filed incorporation papers with the secretary of state. Its co-owners should be seen as partners in their relations with one another. This equation of shareholders' duties in the close corporation to those of partners is typified by the Massachusetts Supreme Judicial Court's opinion in *Donahue v. Rodd Electrotype Co.*:

[182] 164 N.E. 545, 546 (1928).

> Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined the standard of duty owed by partners to one another as the "utmost good faith and loyalty." [183]

Justice Cardozo's stature and eloquence have led courts to overlook the fact that his description in *Meinhard v. Salmon* of rigid fiduciary duties may well not reflect the most appropriate default standard for small business relationships. In the small business, owners are often present on a day-to-day basis so they can directly monitor the performance of their co-owners. This stands in sharp contrast to the publicly held corporation in which passive and geographically dispersed shareholders must rely on strong duties to substitute in part for their inability to actively monitor those who manage their investment.[184]

Also, in the small business, an owner may have extensive dealings with the company. For example, one owner may lease office space or other premises to the

[183] 328 N.E.2d 505, 515 (1975) (footnotes and citation omitted). Also see e.g. Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 661-62 (Mass. Sup. Jud. Ct., 1976); Alaska Plastics v. Coppock, 621 P.2d 270, 276 (Alaska Sup. Ct., 1980); Tills v. United Parts, Inc., 395 So. 2d 618, 619 (Fla. Ct. App., 1981); Crosby v. Beam, 548 N.E.2d 217 (Ohio Sup. Ct., 1989); Balvik v. Sylvester, 411 N.W. 2d 383, 387-88 (ND Sup. Ct., 1987); Fought v. Morris, 543 So. 2d 167, 171 (Miss. Sup. Ct., 1989).

[184] See Larry E. Ribstein, *Are Partners Fiduciaries?*,(May 27, 2004), forthcoming in Illinois Law Review. Draft available at http://home.law.uiuc.edu/~ribstein/partnersasfiduciaries.doc.

business or may license a patent or copyright or trademark to it.[185] Elaborate restrictions on self-dealing designed for other kinds of businesses[186] may be less appropriate here. In some situations, the small business may be so small that it does not demand the full time attention of its manager. It might be common for the manager to be engaged other related business activities. Applying the strict standard of the "corporate opportunity" cases to that kind of arrangement may be inconsistent with the expectations of all the parties involved.[187]

In 1997, the drafters of the Uniform Partnership Act recognized the special issues in smaller businesses and defined more narrowly than does *Meinhard v. Salmon* the fiduciary duties that partners owe to the partnership and to their co-partners.[188]

How should fiduciary duties in the LLC be defined? This encompasses at least three different issues: (1) how strict a duty will be applied[189]; (2) to whom is the duty owed; and (3) may the duty be modified or eliminated through provisions in the operating agreement? As in other areas of LLC law, the LLC statutes vary widely in the extent to which they address these questions at all, and in the answers they give when they do address the questions.

1. Level of Duty

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[185] See e.g. Lewis v. S.L.&E., Inc., 629 F.2d 764 (2d Cir., 1980).

[186] See e.g. MBCA §8.60- §8.63.

[187] See e.g. Burg v. Horn, 380 F.2d 897 (2d Cir., 1967); Victor Brudney & Robert C. Clark, *A New Look At Corporate Opportunities*, 94 Harv. L. Rev. 997 (1981).

[188] Uniform Partnership Act (1997) §404.

[189] See Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, 38 Harv. J. on Legis. 413, 448-51 (2001).

The Uniform Limited Liability Company Act has adopted the same approach as the Uniform Partnership Act as to the level of fiduciary duties.[190] Members and managers have an obligation of good faith and fair dealing.[191] Beyond this, a member in a member-managed LLC, and a manager in a manager-managed LLC have only specified duties of loyalty; they are not subject to the open-ended kind of standard enunciated in *Meinhard v. Salmon*. Their only duties of loyalty are to account for any benefit derived from use of the company's property or from an opportunity belonging to the company; to refrain from dealing with the LLC as, or on behalf of, an adverse party; and to refrain from competing with the LLC (subject to reasonable exceptions in the operating agreement). Moreover, these duties are not violated merely because a member's or manager's conduct furthers that individual's own interest.[192]

As with loyalty, so with duty of care the Uniform Limited Liability Company Act follows the lead of the UPA. A member or manager is liable for breach of duty of care only if the individual's conduct was grossly negligent, reckless, intentional or amounted to a knowing violation of law. LLC members bear the risk of ordinary negligence by those they place in charge of the company. A member in a manager-managed LLC owes no duties to the LLC or other members solely by reason of being a member.[193]

Many other LLC statutes are less forthcoming in providing guidance on members' and managers' duties of loyalty and care. The Delaware statute provides that a member

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[190] See generally, Allan W. Vestal, *Fundamental Contractarian Error In The Revised Uniform Partnership Act of 1992*, 73 B.U.L. Rev. 523 (1993).

[191] Uniform Limited Liability Company Act (1995) §409(d), (h).

[192] Uniform Limited Liability Company Act (1995) §409.

[193] Uniform Limited Liability Company Act (1995) §409(c).

or manager is fully protected if the individual relies in good faith on LLC records or on information, opinions, reports and statements by other managers, members, employees and certain professional experts.[194] This, of course, suggests, that members and managers have certain duties that can be fulfilled in part by relying on others; however the statute does not specify the scope of those duties. While this has not prevented the courts from finding that managers have a duty of loyalty[195], the exact scope of that duty remains unclear.

Some LLC statutes have adopted as the standard for members' or managers' duties the language of the state's corporate provisions relating to directors' obligations. Tennessee, for example, which allows management by members or by a board of governors (and in either event requires designation of a chief manager and a secretary)[196] provides that any of those who manage the LLC must discharge their duties in good faith, in a manner the individual reasonably believes to be in the best interest of the LLC, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.[197] In the section setting out duties of members in a member-managed LLC, the statute also requires that, except as provided in the articles or operating agreement, every member must account to the LLC for any benefit derived from any LLC transaction or from the use of LLC property or proprietary information.[198] It does

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[194] Del. Code Ann., tit.6, §18-406.

[195] VGS, Inc. v. Castiel, 2000 Del. Ch. LEXIS 122 at *12 to *13 (Del. Ct. Chancery, 2000), *aff'd.* 781 A.2d 696 (Del. Sup. Ct., 2001).

[196] Tenn. Code Ann. §48-241-101.

[197] Tenn. Code Ann. §48-239-115 (governor in LLC managed by board of governors); Tenn. Code Ann. §48-240-102 (members in member managed LLC); Tenn. Code Ann. §48-241-111 (managers).

[198] Tenn. Code Ann. §48-240-102(a).

not, however, impose the same added requirement on governors in a board-managed LLC. This oddity seems to be explainable by the fact that drafters borrowed partnership law language for member-managed LLCs, but not for those that would be managed by a board.

Corporate language, like that used in the Tennessee statute, imposes a stricter duty of care on LLC managers and members than does the language of the Uniform Limited Liability Company Act. In *Shell v. King,*[199] the LLC's chief manager delegated all responsibility for depositing cash and preparing financial reports to the LLC's bookkeeper and negligently failed to ever verify whether the correct amounts were in fact being deposited. The bookkeeper embezzled over $26,000. The manager was held liable for breaching his duties to the LLC and its other members. Under the Uniform Limited Liability Company Act, the manager would have been liable only if his failure to check on the bookkeeper amounted to gross negligence.[200]

In contrast, Ohio adopted language from its corporate statute to define duties of LLC managers, but is silent as to duties in a member-managed LLC. The provision on duties of managers includes language that had been placed in the corporate statute to protect corporate directors who defend against a hostile takeover. So a manager must act in good faith, in a manner he believes to be in or not opposed to the best interests of the LLC and with the care that an ordinarily prudent person in a similar position would use under similar circumstances. However, these duties are not violated unless it is proved by clear and convincing evidence that the manager has not met them. Even if this

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[199] 2004 Tenn. App. LEXIS 507 (Aug. 5, 2004).

[200] Uniform Limited Liability Company Act (1995) §409(c), (h). Also see Sandra K. Miller, *supra* note [189] at 443-48.

standard is met, the manager is not liable in damages unless it is proved by clear and convincing evidence that the improper act or omission was undertaken with deliberate intent to injure the LLC or with reckless disregard for its best interests.[201] The effect of this provision seems to be to set the fiduciary duty of managers at a rather low level while retaining an implicitly higher level for members in a member-managed LLC.[202] This seems backwards. The more a business has passive investors who entrust others with managing their investment, the higher should be the duties to those investors.[203]

In short, drafters of LLC statutes have defined the fiduciary duties of LLC members and managers by, seemingly randomly, borrowing language from corporate and partnership statutes. An important piece of any law reform agenda should be an examination of the appropriate level of fiduciary duties in an LLC and a rationalization of fiduciary duties that apply to small businesses of various forms. Should states retain a body of case law that imposes a high *Meinhard*- like duty on shareholders in a closely held corporation without imposing the same duty on LLC members? Should the many states which have adopted the 1997 Uniform Partnership Act[204] retain a higher level of fiduciary duty for LLC members or managers than the UPA imposes on partners?

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[201] Ohio Rev. Code §1705.29.

[202] See McConnell v. Hunt Sports Enters., 725 N.E.2d 1193, 1214-15 (OH Ct. App., 1999).

[203] See Larry E. Ribstein, *supra* note [184].

[204] Twenty-nine states and the District of Columbia have adopted the 1997 UPA; 3 others have adopted the 1992 or 1994 versions of the Act that are similar to the 1997 version. *A Few Facts About the Uniform Partnership Act (1994) (1997*), http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upa9497.asp .

2. To Whom Is the Duty Owed?

An important aspect of the cases which created special duties among shareholders of closely held corporations was their recognition that those duties are owed directly to co-investors. This relieves shareholders in close corporations from complying with the burdensome procedural requirements applied to derivative suits when they are challenging the manner in which fellow shareholders operate the business.[205] LLC statutes create a great deal of uncertainty[206] about whether duties are owed to the LLC itself, or are owed instead directly to LLC members, or even to LLC managers by their co-managers.

The Uniform Limited Liability Company Act takes the position that duties are owed to the company *and* to other members and managers.[207] The problematic nature of this conclusion is illustrated by the Delaware decision in *VGS, Inc. v. Castiel*[208] which takes the same approach. The LLC here was to be managed by 3 managers. Two of the three were to be appointed by Castiel, the member holding a majority interest. Castiel appointed himself and Quinn. The third manager was to be named by Sahagen, the minority investor in the LLC. Sahagen named himself. Castiel's control of the LLC was exercised in such a poor fashion that Sahagen even convinced Quinn (Castiel's own nominee) that Castiel needed to be ousted. This was accomplished by an elaborate

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[205] See e.g. Steelman v. Mallory, 716 P.2d 1282 (Ida. Sup. Ct., 1986); Crosby v. Beam, 548 N.E.2d 217, 221 (Ohio Sup. Ct., 1989); Barth v. Barth, 659 N.E.2d 559 (Ind. Sup. Ct., 1995). Also see American Law Institute, PRINCIPLES OF CORPORATE GOVERNANCE §7.01(d) (1994). But see Frank v. Hadesman & Frank, 83 F.3d 158 (7th Cir., 1996) (derivative action required); Wessin v. Archives Corp., 592 N.W.2d 460, 466-67 (Minn. Sup. Ct., 1999) (derivative action required).

[206] See Sandra K. Miller, *supra* note [189] at 451-53.

[207] Uniform Limited Liability Company Act (1995) §409 and Comment to §409.

[208] 2000 Del. Ch. LEXIS 122 (Del. Ct. Chancery, 2000), *aff'd.* 781 A.2d 696 (Del. Sup. Ct., 2001).

conversion of the LLC into a corporation, carried out by the written consent of Sahagen and Quinn. Castiel was not informed in advance of the plan, since he would have then removed Quinn and thwarted its being carried out. Even though this procedure complied with the literal requirements of the LLC's operating agreement, the court invalidated it:

> Sahagen and Quinn each owed a duty of loyalty to the LLC, its investors and Castiel, their fellow manager. *** When Sahagen and Quinn, fully recognizing that [the power to appoint and remove two of the three managers] was Castiel's protection against actions adverse to his majority interest, acted in secret, without notice, they failed to discharge their duty of loyalty to him in good faith. They owed Castiel a duty to give him prior notice even if he would have interfered with a plan that they conscientiously believed to be in the best interest of the LLC.[209]

Suppose that there had been other investors in the LLC who were not represented on the board of managers. Did Sahagen and Quinn have a duty to permit Castiel to run the LLC into the ground just because he was the majority holder of membership interests? What of their duty to other investors and the LLC itself? This confusion regarding duties of members and managers again cries out for rationalization.

3. May Fiduciary Duties Be Modified or Eliminated?

Should statutory provisions specifying fiduciary duties impose mandatory requirements on LLC members and managers, or should the members be permitted to lessen or eliminate fiduciary duties of co-investors and managers though a provision in the operating agreement? The Uniform Limited Liability Company Act prohibits members from eliminating the duty of loyalty or unreasonably reducing the duty of care

[209] Id. at *12 to *14.

through the operating agreement. However the operating agreement may exempt certain types of activities from the duty of loyalty or provide for members or disinterested managers to waive the duty on a case by case basis.[210] On the other hand, Delaware's statute provides that the duties of a member or manager may be expanded or restricted in the limited liability company agreement.[211] How far does this go? Does "restricting" fiduciary duties include totally eliminating them?

A number of other state LLC statutes say nothing about the ability to use the operating agreement to modify fiduciary duties. Nevertheless, at least one case from a state in which the statute is silent on the matter has clearly held that an LLC operating agreement may limit or define the scope of fiduciary duties imposed on members.[212] Clarifying the extent to which fiduciary duties should be subject to contractual modification is another aspect of LLC law that is in need of analysis. The issue has been extensively debated in the academic literature in the context of fiduciary duties of corporate directors.[213] Do the same considerations apply to LLCs?

D. Dissolution and FLP Issues

The final item on my menu of urgent issues for study and reform by academics relates to the default rules and statutory remedies for dissolution of LLCs. In a partnership at will, a partner has the right to leave the partnership and force it to sell off

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[210] Uniform Limited Liability Company Act (1995) §103(b).

[211] 6 Del. Code §18-1101(c).

[212] McConnell v. Hunt Sports Enters., 725 N.E.2d 1193, 1214 (OH Ct. App., 1999)

[213] See e.g. Victor Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract*, 85 Colum L. Rev. 1403 (1985); John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 Brooklyn L. Rev. 919 (1988); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev. 1 (1990).

its assets, pay off creditors and distribute any surplus to the partners.[214] This escape hatch gives the holder of an otherwise illiquid investment in a small business the power to liquidate his or her investment.[215] But, in the partnership context, this power also serves another, less commented upon, function.

A partner who withdraws from a partnership remains liable to business creditors who pre-date the partner's withdrawal.[216] If the partner leaves the business, cedes control to the remaining partners, but allows the business to continue, the withdrawn partner runs the risk that the others will bankrupt the business and leave him or her with at least some personal liability to business creditors.[217] For the partner who wishes to retire without concern about lingering personal liability, forcing the payment of all creditors in dissolution is the primary alternative available to achieve financial peace of mind.

Membership interests in small LLCs are as illiquid as partnership interests. The importance of an "escape hatch" for the dissatisfied investor who otherwise lacks liquidity remains important in the LLC. However, the limited liability of LLC members for debts of the business eliminates the other justification for permitting a withdrawing member to trigger dissolution. The withdrawing member does not risk personal liability to creditors even if the remaining members incompetently manage the business in the future. At the same time, giving an investor the right to withdraw at will and have his or

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[214] Uniform Partnership Act (1997) §103(b)(6), §601(1), §602(a), §801.

[215] See J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution To the Remaining Close Corporation Problem,* 63 Va. L. Rev. 1 (1977); Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations,* 67 Minn. L. Rev. 1 (1982).

[216] Uniform Partnership Act (1997) §703.

[217] See Robert W. Hillman, *Indissoluble Partnerships*, 37 U. Fla. L. Rev. 691, 701-02, 727-28 (1985).

her interest repurchased by the company imposes significant costs on an LLC.[218] Indeed, one of the distinct advantages of the corporate form is the locking in of investors' capital.[219]

The drafters of LLC statutes were faced with deciding whether to adopt partnership default rules or corporate ones as to whether a member can trigger dissolution by withdrawing. Before the IRS Check-the-Box Regulations were adopted,[220] partnership default rules on dissolution helped assure that LLCs would receive partnership tax treatment. After 1997, however, default rules that locked in capital investments would no longer threaten the LLC's favorable tax treatment. This led a number of states to amend their LLC statutes after 1997 to eliminate dissolution at will as a default rule.[221] While one might imagine that eliminating dissolution at will was a considered balancing of the advantages of an escape hatch for minorities against the costs of forcing liquidation, in fact something else seemed to be at play in many cases.[222] Again the vagaries of federal tax rules often drove the shape of LLC statutes.

LLCs are sometimes used by estate planners as a device for transferring a business from one generation of owners to the next. When the parents' interests are passed to children by gift or inheritance, the value of the interests for estate and gift tax

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[218] See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 Stan. L. Rev. 271, 286-90 (1986).

[219] Margaret M. Blair, *supra* note [35]; Lynn A. Stout, *supra* note [35].

[220] See *infra* ____.

[221] See e.g. Calif. Corp. Code §17350; Off. Code Ga. Ann. §14-11-602; Mich. Comp. Laws §450.4801; NY CLS Limited Liability Company Law §701(b); Ohio Rev. Code §1705.43; Wis. Stat. §183.0901.

[222] For an excellent discussion of the advantages and disadvantages of adopting partnership-like default rules for LLCs, see Sandra K. Miller, supra note [189].

purposes must be determined. Generally a discount is applied to the value of an interest if it is not freely transferable or cannot be freely liquidated.[223] For this reason, lawyers often include in LLC operating agreements limitations on the ability to liquidate one's investment in the LLC on death or withdrawal of one or more of the LLC members, even though there is no good business reason to include this kind of restriction.

In order to avoid the loss of tax revenues that arise from unwarranted valuation discounts, Congress has provided that in family businesses, restrictions on the ability to liquidate an LLC will be ignored for valuation purposes if the default rule under state law would be less restrictive and the restriction will lapse after the business is passed on or family members can remove the restriction once they obtain control of the LLC.[224] It is this, rather than a considered balancing of other business concerns, that led a number of states to make certain that they do not have a default rule that permits a member to easily cash out his or her interest in an LLC.[225]

The focus on estate tax planning as the driving force in shaping of dissolution provisions in LLCs has led legislatures to ignore many of the non-tax implications of corporate-like default rules for dissolution. As Prof. Sandra Miller suggests, perhaps legislatures should shape the default rules of another type of unincorporated business form to make it attractive as an estate and gift tax planning device for passing on small

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[223] See e.g. Steven T. Ledgerwood, *Oklahoma LLCs vs. Limited Partnerships: Choice of Entity for Valuation Discounts After 1997*, 22 Okla. City U. L. Rev. 611 (1997).

[224] See IRC §2704(b)-(c); 26 CFR §25.2704-2.

[225] See Sandra K. Miller, *supra* note [189] at 414 -15.

businesses.[226] Then legislators could focus on the business needs of the more typical small business in the state's LLC statute.

Drafters of corporate statutes recognized that the absence of an escape hatch for shareholders posed special problems in the closely held corporation where there was no ready market for the company's shares. A locked-in minority shareholder could be subject to exploitation. The shareholder might be frozen out by the majority that eliminates the shareholder's employment with the company and cuts off dividends, but continues to pay high salaries to other shareholders who still work in the business. Traditionally, the minority shareholder was then often left with the choice of suing, or selling out to the minority at an artificially low price.[227]

To create a remedy for this type of oppressive conduct, many states enacted special corporate dissolution statutes that can be invoked by minority shareholders when they are being treated oppressively by the majority.[228] Only a few states, however, included these kinds of dissolution provisions in their LLC statutes.[229] Particularly in states which initially had partnership-like exit provisions in their LLC statutes and then changed to default rules that locked in investors, drafters likely overlooked the issue. Because the elimination of dissolution at will provisions were driven by estate and gift tax concerns, the larger issues relating to the business relationships of the parties in the typical LLC never surfaced.

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[226] Id. at 442-43.

[227] See generally F. Hodge O'Neal & Robert B. Thompson, OPPRESSION OF MINORITY SHAREHOLDERS (2d ed., 2003).

[228] See e.g. MBCA §14.30(2)(ii).

[229] See e.g. Alaska Stat. §10.50.410; Cal. Corp. Code §17351; Idaho Code §53-643; 805 Ill. Compiled Stat. Ann. §180/35-1; Minn. Stat. §322B.833. Also see Sandra K. Miller, *supra* note [189] at 460- 65.

The typical LLC statute, borrowing language from the Prototype Limited Liability Company Act, permits court-ordered dissolution when it is no longer practicable to carry on the LLC's business in conformity with its operating agreement.[230] Occasionally it is clear that this statutory standard has been met.[231] It is less clear however whether an attempt by the majority to freeze out the minority owner of an LLC would make it impracticable to carry on business in accordance with the operating agreement. The drafters of the Prototype Act are remarkably opaque about this important question. The Commentary to the Judicial Dissolution provision in the Prototype Act begins by stating:

> The "not reasonably practicable" language probably includes at least some of the causes of dissolution provided for in partnership law, particularly including partner misconduct.[232]

That suggests that a freeze-out might trigger potential judicial dissolution. [233] But then the Commentary goes on to describe broad provisions (like "abuse of its powers contrary to the public policy of the state") found in many corporate statutes[234] permitting judicial dissolution of a corporation and concludes by stating:

> If an LLC could be judicially dissolved (and the members arguably subjected to personal liability) for such indefinite concepts as the violation of public policy,

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[230] E.g. Del. Code Ann., tit.6, §18-406; Ky. Rev. Stat. Ann. §275.290; Ann. L. Mass. GL Ch. 156C §44; Mich. CLS §450.802; N.J. Stat. §42:2B-49; Oh. Rev. Code §1705.47; NY CLS LLC §702; 15 Pa. C.S. §8972; Va. Code Ann. §13.1-1047.

[231] See McConnell v. Hunt Sports Enters., 725 N.E.2d 1193, 1222-23 (OH Ct. App., 1999).

[232] Prototype Limited Liability Company Act, *supra* note [61], §902 Commentary.

[233] See Louis F. Lobenhofer, *Limited Liability Entities in Ohio: A Primer on the Limited Liability Company and Partnerships with Limited Liability, Their Substantive and Tax Aspects*, 21 Ohio N.U.L. Rev. 39, 80 (1994).

[234] The Commentary does not mention corporate law provisions, like MBCA §14.30(2)(ii), that permit judicial dissolution for "oppressive" conduct by those in control.

disgruntled members and creditors would be encouraged to make this sort of allegation in limited liability company breakups.[235]

While the drafters of the Prototype Act's judicial dissolution language may have been wary of applying broad language in corporate statutes to LLCs, it would indeed be an odd result if the LLC statute, which is supposed to create a hybrid business form, gives less possibility of an exit for a disgruntled minority investor than does the law applicable to closely-held corporations which, at least in theory, are supposed to lock in capital to a greater degree than other business forms. Development of an appropriate balance in the complex area of LLC dissolution then remains another item on the unfinished agenda for law reform.[236]

VI.

Conclusion

In the space of only a few years, limited liability companies have come to rival corporations as the form of choice for the closely-held business. This is made clear by current data on business filings. Practicing lawyers have embraced this flexible business form, understanding that from both a tax and business perspective it offers clients many advantages. Academic commentators have largely ignored the sea change in choice of business form that these numbers confirm. Law teachers, casebook authors, bar examiners and law publishers act as if partnerships, rather than LLCs, are still the major alternative to corporations. This has created significant costs through suboptimal legal education and neglected legal scholarship.

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[235] Prototype Limited Liability Company Act, *supra* note [61], §902 Commentary.

[236] For one examination of the problem and suggestions for reform, see Sandra K. Miller, *supra* note [193] at 454-66.

Law students, the next generation of lawyers, are being poorly served by the present state of affairs. By and large they are leaving law school without an understanding of the details or the importance of this hybrid business form. The absence of significant amounts of academic research into limited liability companies has also left largely unexplored a number of basic policy and interpretive issues about the law governing this growingly important business form.

The widespread acceptance of limited liability companies in the business world cries out for greater notice. Academics remain in denial. While there are explanations and rationalizations for this, there are few legitimate excuses for the prevailing state of affairs. Law teachers, law schools, publishers and bar examiners need to move rapidly to raise LLCs to their rightful place in legal education and legal study.

APPENDIX

This Appendix sets out the raw data on corporate and LLC filings by state for the years 2002 and 2003. Most of the data is taken from 2003 and 2004 International Association of Commercial Administrators, *Annual Report of Jurisdictions*. Each of these reports contained two years' data for most (but not all) of the reporting jurisdictions. Thus the 2003 Report contained data for 2001 and 2002; the 2004 Report contained data for 2002 and 2003. The 2002 data should have been identical in both reports. Surprisingly, 15 states reported different data for 2002 in the two reports. Where that occurred, to be consistent I have used the 2002 data reported in the 2004 IACA

Report, though in at least two cases (North and South Dakota), it appears that this may not be the most reliable of the two figures.[237]

Some states did not report data to IACA. In those cases I have obtained the data from some other source. Footnotes to the data indicate each source relied upon when the source was not one of the two IACA Reports.

2002 Data on Business Filings

State	Domestic Corporations	Foreign Corporations	LLCs (Domestic and Foreign)
Alabama	6,273	2,816	8,384
Alaska	844	561	1,239
Arizona	11,515	2,596	21,923
Arkansas	5,956	1,715	5,161
California	78,935	10,945	37,429
Colorado	19,144	2,428	21,010
Connecticut	2,532	3,337	25,847
Delaware	36,256	904	47,726
Dist. of Columbia[238]	4,207	[incl. in Domestic]	3,281
Florida	135,578	6,458	38,639
Georgia	31,787	3,429	24,186
Hawaii	3,030	1,008	3,778
Idaho	2,732	1,396	4,309
Illinois[239]	42,950	3,512	15,675
Indiana	11,237	2,441	11,283
Iowa	4,338	1,651	4,863
Kansas	4,547	1,702	5,819
Kentucky[240]	6,926	2,693	10,903
Louisiana	6,267	2,042	16,593
Maine	2,592	1,118	1,984
Maryland	16,867	4,037	17,149
Massachusetts	12,544	3,153	7,465

[237] See discussion *supra* at ___.

[238] DC data from public records search on LEXIS. Includes non-profits.

[239] IL data obtained through e-mails from Robert Durchholz, Dept. of Business Services, Illinois Secretary of State's Office (July 21 and 22, 2004).

[240] KY Secretary of State Annual Business Filing Statistics, http://www.kysos.com/BUSSER/BUSFIL/annualstatistics.asp (visited 7/13/04).

Michigan	20,964	4,145	30,964
Minnesota	13,254	1,946	9,055
Mississippi	4,375	1,569	5,774
Missouri	12,550	[incl. in Domestic]	16,515
Montana	2,120	1,304	N/A
Nebraska	2,966	1,177	2,663
Nevada	28,612	2,093	16,663
New Hampshire	1,680	1,171	5,092
New Jersey	25,543	3,986	32,854
New Mexico	2,259	1,507	4,406
New York	77,650	5,279	34,193
North Carolina	20,975	5,166	18,158
North Dakota	989	1,350	900
Ohio	15.095	3,204	26,575
Oklahoma[241]	6,771	1,880	8,784
Oregon	8,710	2,123	13,249
Pennsylvania	18,159	3,937	13,302
Rhode Island	2,403	1,057	2,681
South Carolina[242]	8,934	3,200	12,643
South Dakota	14,954	9,535	5,185
Tennessee	7,143	2,109	7,267
Texas[243]	48,188	8,131	32,953
Utah	10,303	1,766	13,215
Vermont	778	895	1,863
Virginia	19,232	4,660	19,599
Washington	12,069	3,106	15,313
West Virginia	1,320	1,642	2,618
Wisconsin	5,780	1,584	18,192
Wyoming	2,269	1,341	2,914

2003 Data on Business Filings

State	Domestic Corporations	Foreign Corporations	LLCs (Domestic and Foreign)
Alabama	6,037	2,482	10,418
Alaska	870	543	1,883
Arizona[244]	13,075	2,483	28,762

[241] OK data obtained through e-mail from James Martin, Oklahoma Secretary of State's office, July 19, 2004.

[242] SC data obtained from public records search on LEXIS.

[243] Includes non-profits.

[244] 2003 AZ data from Arizona Corporation Commission website, <www.cc.state.az.us> ("Records"/"Information on Active Corporations"/"Statistics").

Arkansas	5,897	1,668	6,443
California	83,763	9,933	45,274
Colorado	16,976	2,407	19,383
Connecticut	2,498	3,176	25,255
Delaware	32,180	843	49,551
Dist. of Columbia[245]	3,547	[incl. in Domestic]	4,434
Florida	161,559	6,521	62,406
Georgia	32,311	3,210	30,806
Hawaii	3,195	1,199	4,988
Idaho[246]	3,055	1,549	5,575
Illinois[247]	44,348	3,387	21,450
Indiana	11,184	2,448	13,707
Iowa	4,384	1,380	5,902
Kansas	4,419	1,611	7,067
Kentucky[248]	6,799	2,360	12,928
Louisiana	5,694	1,928	20,121
Maine	2,639	1,020	3,224
Maryland	17,031	3,916	21,980
Massachusetts	11,941	2,974	9,999
Michigan[249]	20,780	2,216	36,495
Minnesota	13,545	1,862	13,765
Mississippi	4,170	1,434	6,938
Missouri	12,132	[incl. in Domestic]	21,318
Montana	2,537	1,419	5,740
Nebraska	3,017	1,078	3,469
Nevada	29,120	1,978	21,011
New Hampshire	1,737	1,380	6,423
New Jersey	22,198	4,126	40,714
New Mexico	2,370	1,495	5,769
New York	78,104	5,169	40,768
North Carolina	21,841	5,229	22,604
North Dakota[250]	13,914	11,270	4,290

[245] DC data from public records search on LEXIS. Includes non-profits.

[246] 2003 Idaho data from Idaho Secretary of State web site, Business Entities, <www.idsos.state.id.us/corp/bestats.htm>.

[247] IL data obtained through e-mails from Robert Durchholz, Dept. of Business Services, Illinois Secretary of State's Office (July 21 and 22, 2004).

[248] KY Secretary of State Annual Business Filing Statistics, http://www.kysos.com/BUSSER/BUSFIL/annualstatistics.asp (visited 7/13/04).

[249] 2003 MI data from Mich. Dept. of Labor & Economic Growth website, <www.michigan.gov/cis/0,1607,7-154-10557_12901_12923-37342--,00.html>.

[250] See discussion of questionable accuracy of these figures, *supra* __.

Ohio	13,866	2,735	31,147
Oklahoma[251]	6,588	1,575	10,250
Oregon	8,912	2,168	17,469
Pennsylvania	17,888	3,055	16,472
Rhode Island	2,337	969	3,629
South Carolina[252]	8,599	2,944	15,020
South Dakota[253]	15,379	9,666	6,264
Tennessee	7,209	2,131	8,704
Texas[254]	46,694	8,413	35,285
Utah	7,785	2,134	13,148
Vermont[255]	1,217	1,093	2,262
Virginia	19,337	4,511	24,673
Washington	12,394	3,161	18,917
West Virginia	1,455	2,812	3,913
Wisconsin	5,643	1,528	22,229
Wyoming	1,977	1,394	3,124

[251] OK data obtained through e-mail from James Martin, Oklahoma Secretary of State's office, July 19, 2004.

[252] SC data obtained from public records search on LEXIS.

[253] See discussion of questionable accuracy of these figures, *supra* __.

[254] Includes non-profits.

[255] 2003 VT data from Vermont Secretary of State website, "New Business Start-Ups", <www.sec.state.vt.us/tutor/dobiz/numbers.htm>.