ABOLISHING LLC VEIL PIERCING

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Courts are now routinely applying the corporate law doctrine of veil piercing to limited liability companies (LLCs). This extension of a seriously flawed doctrine into a new arena is not required by statute and is insupportable as a matter of policy. The standards by which veil piercing is effected are vague, leaving judges great discretion. The result has been uncertainty and lack of predictability, thus increasing transaction costs for small businesses. At the same time, however, there is no evidence that veil piercing has been rigorously applied to effect socially beneficial policy outcomes. Judges typically seem to be concerned more with the facts and equities of the specific case at bar than with the implications of personal shareholder liability for society at large.

A standard academic approach treats veil piercing as a safety valve allowing courts to address cases in which the externalities associated with limited liability seem excessive. In doing so, veil piercing is called upon to achieve such lofty goals as leading LLC members to optimally internalize risk, while not deterring capital formation and economic growth, but while promoting populist notions of economic democracy. Given the vagueness of veil piercing doctrine and the arbitrariness with which it is applied, however, veil piercing is too weak a tool by which to accomplish so much. Abolishing veil piercing would refocus judicial analysis on the appropriate question—did the defendant-LLC member do anything for which he or she should be held directly liable?

I. INTRODUCTION

Several years ago I wrote an article entitled *Abolishing Veil Piercing*, whose titular thesis called on courts to scrap the doctrine known as piercing the corporate veil.[1] The standard justification for veil piercing argues that it serves as a safety valve allowing courts to address cases in which the externalities associated with limited liability seem excessive.[2]

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1. Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479 (2001).

2. As a leading text observes:

Finally, the doctrine of piercing the corporate veil allows courts to impose liability on shareholders in appropriate cases, notwithstanding the limited-liability rule. . . . As a practical matter, As such, veil piercing is called upon to achieve such lofty goals as leading shareholders to optimally internalize risk, while not deterring capital formation and economic growth, but while promoting populist notions of economic democracy.[3] The task is untenable. Veil piercing is rare, unprincipled, and arbitrary.[4] Such a doctrine is highly unlikely to consistently effect socially beneficial policy outcomes. Instead, veil piercing achieves neither fairness nor efficiency, but rather only uncertainty and lack of predictability, thus increasing transaction costs for small businesses.[5]

I therefore argued for abolishing veil piercing so as to refocus judicial analysis on the appropriate question, which I posited to be: Did the defendant-shareholder do anything for which he or she should be held directly liable?[6] For example, did the shareholder commit fraud, which led a creditor to forego contractual protections? Or did the shareholder use fraudulent transfers or insider preferences to siphon funds out of the corporation?

In this article, my attention turns to limited liability companies (LLCs).[7] Under all LLC statutes, members of a LLC—like shareholders of a corporation—are not personally liable for the firm's obligations.[8] The obvious question is whether courts should export the corporate veil piercing doctrine to the LLC context. Some LLC statutes seem to command courts to do so.[9] Even in the absence of such a statutory command,

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> therefore, the piercing doctrine may act as a safety valve that takes some of the pressure off the limited liability rule in cases where the rule is most dubious.

WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 191 (7th ed. unabr. 1995).

3. *See* Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148, 155–56 (1992) (arguing that limited liability was originally rooted in a legislative desire to encourage small and impecunious entrepreneurs to start and grow new businesses); *see also* CARY & EISENBERG, *supra* note 2, at 190 (explaining that "State legislatures in particular often seem to put much more weight on promoting local business formation than on requiring the internalization of externalities.").

4. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89 (1985) (explaining that veil piercing "seems to happen freakishly. Like lightning, it is rare, severe, and unprincipled."); *cf.* Berkey v. Third Ave. Ry. Co., 155 N.E. 58, 61 (N.Y. 1926) (Cardozo, J.) (opining that veil piercing is a doctrine "enveloped in the mists of metaphor").

5. *See* Bainbridge, *supra* note 1, at 515 (arguing that the veil piercing doctrine "is inconsistent with the goals of certainty and predictability").

6. *Id.* at 516.

7. This article assumes familiarity with the LLC form. *See generally* J. William Callison, *Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business*, 26 J. CORP. L. 97 (2000); William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855 (1995); Wayne M. Gazur, *The Limited Liability Company Experiment: Unlimited Flexibility, Uncertain Role*, 58 LAW & CONTEMP. PROBS. 135 (1995); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992); Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. LAW. 499 (2001); Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1 (1995) [hereinafter Ribstein, *Emergence*]; Larry E. Ribstein, *The New Choice of Entity for Entrepreneurs,* 26 CAP. U. L. REV. 325 (1997).

8. *See, e.g.*, UNIF. LTD. LIAB. CO. ACT § 303(a), 6A U.L.A. 590 (2003).

9. *See, e.g.*, MINN. STAT. § 322B.303(2) (2003).

however, courts are routinely applying the corporate law doctrine to LLCs.[10] Most are doing so in a way that can only be described as unthinking.[11]

My thesis herein is that the case for limited liability—and therefore the case against veil piercing—applies with equal force to LLCs as to corporations. Accordingly, other than in those jurisdictions whose statute commands courts to do so, courts have erred by importing the corporate veil piercing doctrine into LLC law.[12]

Part II of this article reviews the emerging legal landscape. Part III advocates abolishing the veil piercing doctrine in the context of LLCs. Instead, as I proposed with respect to corporations, Part III advocates a regime of direct liability: Did the defendant-members do anything for which they are appropriately held personally liable?

II. LAW

In corporate law, the doctrine of limited liability holds that shareholders of a corporation generally are not liable for debts incurred or torts committed by the firm.[13] Shareholder losses when the firm faces financial difficulties are limited to the amount the shareholder has invested in the firm—i.e., the amount initially paid by the shareholder to purchase his stock.

Despite the statutory guarantee of limited liability for shareholders of a corporation, however, unlimited personal liability may be involuntarily thrust upon a shareholder via the equitable remedy known as piercing the corporate veil.[14]

10. *See infra* note 27 and accompanying text.

11. *See infra* note 29 and accompanying text.

12. At the outset, however, a distinction must be drawn between veil piercing and enterprise liability. Allocating liability within a business enterprise comprised of multiple corporations and/or LLCs involves far different policy considerations than does holding liable the natural persons who own a limited liability company. These tasks should be unbundled. Intra-corporate group liability issues should be dealt with as a species of enterprise liability, while the liability of individual LLC members is the proper subject of veil piercing law. In this Article, I propose retaining enterprise liability to deal with allocating liability within business enterprises that include LLCs, including the liability of parent corporations or LLCs for the acts of their subsidiaries, while eliminating the doctrine of veil piercing insofar as it would allow imposition of personal liability on the ultimate owners of the LLC (whether they be natural persons or institutional investors).

13. *See, e.g.*, MODEL BUS. CORP. ACT § 6.22 Supp. (1998).

14. There is substantial disagreement in the case law as to whether veil piercing is an equitable or legal doctrine. The significance of the issue, of course, is that equitable remedies need not be tried before a jury but parties subject to legal remedies generally are entitled to trial by jury. *See also* Wm. Passalacqua Builders, Inc. v. Resnick Developers S., Inc., 933 F.2d 131, 136 (2d Cir. 1991) (veil piercing has roots in both law and equity, so it was proper for trial court to submit issue to jury); Am. Protein Corp. v. AB Volvo, 844 F.2d 56, 59 (2d Cir. 1988) (veil piercing is an equitable remedy but issue is normally submitted to a jury); *Compare* United States v. Golden Acres, Inc., 684 F. Supp. 96, 103 (D. Del. 1988) (veil piercing is equitable remedy and affords no right to jury trial), *and* Dow Jones Co. v. Avenel, 198 Cal. Rptr. 457, 460 (Cal. Ct. App. 1984) (same), *with* Bower v. Bunker Hill Co., 675 F. Supp. 1254, 1261–62 (E.D. Wash. 1986) (veil piercing a legal remedy because it seeks a money judgment and thus a right to jury trial exists).

> The "veil" of the "corporate fiction," or the "artificial personality" of the corporation is "pierced," and the individual or corporate shareholder exposed to personal or corporate liability, as the case may be, when a court determines that the debt in question is not really a debt of the corporation, but ought, in fairness, to be viewed as a debt of the individual or corporate shareholder or shareholders.[15]

Or, as a seminal 1912 law review article put it:

> When the conception of corporate entity is employed to defraud creditors, to evade an existing obligation, to circumvent a statute, to achieve or perpetuate monopoly, or to protect knavery or crime, the courts will draw aside the web [i.e., veil] of entity, will regard the corporate company as an association of live, up-and-doing, men and women shareholders, and will do justice between real persons.[16]

LLC statutes likewise provide limited liability for LLC members. Section 303 of the Uniform Limited Liability Company Act (ULLCA), for example, states that:

> The debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.[17]

Given the corporate precedent, the question inevitably arose whether corporate law's veil piercing rules carried over to the LLC context. Courts and commentators have uniformly concluded that the LLC form does not provide truly unlimited limited liability; rather, the LLC veil may be pierced in appropriate circumstances.[18] In some cases they were

15. STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL § 1:1, at 1-6 (1991) (footnotes and emphasis omitted). Shareholders may also face personal liability in connection with watered stock or unlawful dividends. In some states, special statutory provisions impose personal liability on shareholders with respect to certain corporate debts. New York and Wisconsin, for example, do so with respect to certain debts to corporate employees. *Id.* & n.14.

16. I. Maurice Wormser, *Piercing the Veil of Corporate Entity,* 12 COLUM. L. REV. 496, 517 (1912). For an overview of the modern law of piercing the corporate veil and related doctrines, see STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 151–71 (2002).

17. UNIF. LTD. LIAB. CO. ACT § 303(a), 6A U.L.A. 590 (2001).

18. *See* Kaycee Land & Livestock v. Flahive, 46 P.3d 323, 327–28 (Wyo. 2002) (citing authorities). In some regulatory settings, veil piercing-like standards are mandated by statute or rule. In plant closing litigation arising under the federal Worker Adjustment and Retraining Notification ("WARN") Act, 29 U.S.C. §§ 2101–2109 (2000), for example, the issue often arises as to whether corporate or LLC subsidiaries should be treated as a "single employer" along with their parents. The federal Department of Labor has promulgated a standard closely resembling corporate veil piercing for use in making that determination. UAW Local 157 v. OEM/Erie Westland, LLC, 203 F. Supp. 2d 825, 832–33 (E.D. Mich. 2002). In addition, courts often supplement the Department of Labor standard with ordinary corporate veil piercing principles. *Id*. at 833. These regulatory requirements are beyond the scope of this article.

Also beyond the scope of this article is the use of veil piercing-based theories in procedural settings. *See, e.g.*, Hesni v. Williams & Boshea, LLC, No. CIV.A. 01-3745, 2002 WL 373273 (E.D. La. Mar. 7, 2002) (holding that because plaintiff would be able to pierce the LLC's veil to hold an individual personally liable consent of that individual was required in order for the case to be removed to federal court).

compelled to reach this result by statute, but they have done so even when the statute was silent.[19]

A. Statutes Invoking Veil Piercing

Minnesota's LLC statute provides that "case law that states the conditions and circumstances under which the corporate veil of a corporation may be pierced under Minnesota law also applies to limited liability companies."[20] In *Tom Thumb Food Markets, Inc. v. TLH Properties, LLC*,[21] one Hartmann, acting for TLH, agreed to build a building for Tom Thumb on property owned by one Smith. Hartmann represented that he owned the property.[22] In fact, Hartman did not own the property, but believed that he had a deal with one Smith to develop it.[23] After the project fell through, Tom Thumb sued, seeking to pierce TLH's LLC veil and hold Hartmann personally liable.[24] On appeal, the court held that, under the express terms of the Minnesota LLC statute, the law relating to piercing the corporate veil applies to LLCs.[25] On the facts, however, the court held that Tom Thumb had failed to establish the element of injustice or fundamental unfairness necessary to pierce the veil.[26]

19. The statutory language governing LLC member liability "varies significantly among the states." Rebecca J. Huss, *Revamping Veil Piercing for all Limited Liability Entities: Forcing the Common Law into the Statutory Age,* 70 U. CIN. L. REV. 95, 101 (2001). For a useful taxonomy of the various approaches states have taken to the question of LLC member liability, albeit one whose assignments of individual states to particular approaches is now out-of-date, see Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 14–18 (1997) (analyzing the various state LLC statutes).

20. MINN. STAT. ANN. § 322B.303(2) (West 2004). At one time, a number of other states had similar provisions, although these have largely faded away. *See* Ribstein, *Emergence, supra* note 7, at 9.

21. No. C9-98-1277, 1999 WL 31168 (Minn. Ct. App. Jan. 26, 1999).

22. *Id.* at *1.

23. *Id.*

24. *Id.*

25. *Id.* *3.

26. *Id.* Minnesota's corporate veil piercing standard is a two-pronged one, requiring proof both that (1) the corporation is a mere alter ego of the shareholder and (2) that failing to pierce would allow some injustice or fundamental unfairness to the plaintiff to go unremedied. Gallinger v. N. Star Hosp. Mut. Assurance, Ltd., 64 F.3d 422, 427 (8th Cir. 1995).

In *Gallinger*, the court held that the second prong was not satisfied and that the veil should not be pierced. Student commentator Shaun Klein critiqued *Gallinger* as imposing too demanding a standard for piercing the LLC veil and, accordingly, argued for a legislative change to make veil piercing easier. Shaun M. Klein, Comment, *Piercing the Veil of the Limited Liability Company, From Sure Bet to Long Shot: Gallinger v. North Star Hospital Mutual Assurance, Ltd.*, 22 J. CORP. LAW. 131 (1996). Klein's analysis has been cited with approval by some other commentators, perhaps most notably by David Cohen, who observed that:

> This case is interesting in that it seems to recognize that LLCs are different from corporations and, perhaps as a result, the court argued that although the elements of the first requirement for piercing the veil exist, since the firm was created as an LLC the second prong is weakened to such a degree that no piercing can exist as a matter of law.

David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules For Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427, 454–55 n.142 (1998). In fact, however, the entity at issue in *Gallinger* was not a limited liability company, at least in the sense that that term is

B. Silent Statutes

Absent a Minnesota-like statute mandating the use of corporate veil piercing precedents in determining the personal liability of members of a LLC, should a court import the corporate law doctrine into the LLC arena? Given the availability of corporate law doctrines as a ready made body of law close at hand, doing so has proven an irresistible impulse.[27] Some courts even refer to the relevant cause of action as being one to "pierce the corporate veil" of a LLC.[28] The analysis in most of these cases is perfunctory at best; most simply assume the corporate law standard applies and have done with it.[29]

The Connecticut statute, for example, provides that "a person who is a member or manager of a limited liability company is not liable, *solely* by reason of being a member or manager . . . for a debt, obligation or liability" of the LLC.[30] Connecticut courts have read the word "solely" as permitting imposition of unlimited personal liability on grounds other

typically used. To the contrary, the entity in question was formed in Bermuda under a statute treating its "members in a manner analogous to shareholders in a corporation." *Gallinger*, 64 F.3d at 424. Hence, *Gallinger* should not be treated as precedent in LLC cases.

27. *See, e.g.*, Hollowell v. Orleans Reg'l Hosp. LLC, 217 F.3d 379, 385 n.7 (5th Cir. 2000); Int'l Bancorp LLC v. Societe des Bains de Mer et Du Cercle des Estrangers a Monaco, 192 F. Supp. 2d 467, 477–78 (E.D. Va. 2002); NetTech Solutions LLC v. ZipPark.com, No. 01 Civ. 2683 (SAS), 2001 WL 1111966 at *11 (S.D.N.Y. Sept. 20, 2001); GMAC Commercial Mortgage Corp. v. Gleichman, 84 F. Supp. 2d 127, 145 (D. Me. 1999); *In re* Sanner, 218 B.R. 941, 947 (Bankr. D. Ariz. 1998); Ditty v. Checkrite, Ltd., 973 F. Supp. 1320, 1335 (D. Utah 1997); Litchfield Asset Mgmt. Corp. v. Howell, 799 A.2d 298, 309–16 (Conn. App. Ct. 2002); Bonner v. Brunson, 585 S.E.2d 917, 918 (Ga. Ct. App. 2003); Hamilton v. AAI Ventures, LLC, 768 So. 2d 298, 302 (La. Ct. App. 2000); Stauffacher v. Lone Star Mud, Inc., 54 S.W.3d 810, 815–16 (Tex. App. 2001).

Some courts have done even stranger things when it comes to veil piercing in the LLC context. In *New Horizons Supply Cooperative v. Haack*, No. 98-1865, 1999 Wisc. App. LEXIS 108 (Jan. 28, 1999), the trial court decided to treat the LLC as though it were a partnership, and imposed personal liability on the members, mainly because the LLC was treated as a partnership for tax purposes. *Id.* at *6. The appeals court reversed that holding, but imposed personal liability on the alternative grounds that the member did not follow proper procedures for dissolution and did not prove that the amounts distributed to her on dissolution were less than the amount of the debt to New Horizons. *Id.* at *9.

28. *See, e.g.*, Stone v. Frederick Hobby Assoc. II, No. CV0001816205, 2001 WL 861822 at *6 (Conn. Super. Ct. July 10, 2001); Advanced Tel. Sys. Inc. v. Com-Net Prof'l Mobile Radio LLC, 59 Pa. D. & C.4th 286, 289 (Pa. C. P. 2002).

29. In *Rafferty v. Noto Brothers Const., LLC*, No. CV00082596 WL 459073 (Conn. Super. Ct. Apr. 17, 2001), for example, the court simply stated: "The protection afforded by the L.L.C. is not unlimited and may be disregarded, as in the case of a corporation, when the L.L.C. is the alter ego or business conduit of individuals." *Id.* at *1 (citing other unpublished opinions). In *Ditty v. Checkrite, Ltd., Inc.*, 973 F. Supp. 1320 (D. Utah 1997), the court contented itself with the observation that "most commentators *assume* that the [veil piercing] doctrine applies to limited liability companies." *Id.* at 1335 (emphasis added). *See also* NetTech Solutions LLC, 2001 WL 1111966, at *11 (applying the corporate standard without analysis of difference in entities); Great Neck Plaza, L.P. v. Le Peep Rest., LLC, 37 P.3d 485, 489–90 (Colo. Ct. App. 2001) (affirming trial court's piercing of the LLC veil without analysis of the LLC issues); Collins v. E-Magine, LLC, 739 N.Y.S.2d 15, 17 (App. Div. 2002) (rejecting plaintiff's alter ego liability theory for failure of proof rather than as legally insufficient).

30. CONN. GEN. STAT. § 34-133(a) (2003) (emphasis added).

than mere LLC membership and, moreover, have invoked the corporate veil piercing rules to supply the requisite grounds.[31]

The statute admittedly does not preclude the interpretation given it by the Connecticut courts. Yet, other interpretations were readily available. The legislature's use of the word "solely" could be understood as suggesting only that a LLC member or manager may be held personally liable on some basis other than his mere status as such.[32] For example, a member who guarantees a LLC debt may be held personally liable if the LLC fails to perform.[33] Likewise, a member can be held personally liable where he committed a tort for which the entity is also liable.[34] Similarly, if the member or manager fraudulently induced a creditor to lend to the LLC, the member or manager could be held personally liable for committing fraud.[35] Perhaps the legislature used the word "solely" to avoid foreclosing the prospect of direct personal liability of a member or manager arising out of his own conduct in cases such as those just described. If so, there was no need to import the corporate veil piercing rules. Yet, the Connecticut courts have failed to seriously examine this alternative interpretation of their statute.

Securities Investor Protection Corp. v. R.D. Kushnir & Co.[36] offers an even better example of just how poor the analysis in many of these cases has been. The original Illinois LLC statute contained a provision pursuant to which members of a LLC were "'personally liable for any act, debt, obligation, or liability of the limited liability company or another member or manager to the extent that a shareholder of an Illinois business corporation is liable in analogous circumstances under Illinois law.'"[37] This phrasing plausibly can be interpreted as inviting courts to extend the corporate veil piercing doctrine to the LLC context: "The wording of the statute allows one to make the inferential leap that because a corporate shareholder can be subject to veil piercing and thereby

31. *See, e.g.*, Bastan v. RJM & Assoc., LLC, No. CV99-0593189-S, 2001 WL 1006661, at *1 (Conn. Super. Ct. Jun. 4, 2001) (citing the relevant statute and holding that it did not foreclose veil piercing); *see also* Thompson, *supra* note 19, at 20 (arguing that "the use of 'solely' leaves room for other grounds [for setting aside the protections of limited liability] based on traditional common-law corporate principles for piercing the veil").

32. In *Pepsi-Cola Bottling Co. of Salisbury, Md. v. Handy*, No. 1973-S, 2000 WL 364199 (Del. Ch. Mar. 15, 2000), Delaware Vice Chancellor Jacobs reviewed the similar Delaware LLC statute. Interestingly, Jacobs did not seize on the word "solely" to justify veil piercing. Instead, he parsed the facts and determined that the individual defendants had engaged in at least some of the challenged wrongdoing before the LLC was formed. As such, their liability did not arise solely from their status as LLC members, and plaintiff was entitled to proceed against them individually. *Id.* at *3–4. This is precisely the sort of analysis which courts ought to undertake in the face of such statutes, as compared to the simplistic assumption that corporate veil piercing standards apply.

33. Karin Schwindt, *Limited Liability Companies: Issues in Member Liability*, 44 UCLA L. REV. 1541, 1549 (1997).

34. *Id.* at 1548–49.

35. *Cf.* BAINBRIDGE, *supra* note 16, at 174 (discussing direct actions against corporate shareholders in such settings).

36. 274 B.R. 768 (Bankr. N.D. Ill. 2002).

37. *Id.* at 775 n.1 (quoting statute).

exposed to personal liability, so too can an LLC member."[38] Illinois subsequently repealed that statute however, and replaced it with one tracking section 303 of the ULLCA, providing in pertinent part that:

> (a) Except as otherwise provided in subsection (d) of this Section, the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.
>
> . . . .
>
> (c) The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.[39]

If the original wording permitted a pro-veil piercing inference, perhaps one should infer that the subsequent legislative action was intended to preclude extension of the veil piercing doctrine to the LLC setting. The legislature repealed a statute inviting such an extension, replacing it with one containing a flat prohibition of imposing liability on the members of a LLC. The bankruptcy judge, however, failed even to address this interpretation. Instead, the judge simply quoted the relevant statutes and then opined:

> It would seem from the foregoing that "members" or "managers" of an Illinois limited liability company cannot be held liable for the mere failure to observe corporate formalities or repayment, but nothing in the statute bars piercing of the "corporate veil" for other grounds on which that may be done for ordinary corporations.[40]

Why does the statute have to explicitly bar veil piercing? What else does the judge think the legislature was doing? Granted, the legislative action is not dispositive, because the statutory change in question here was part of a larger package of amendments.[41] In addition, because failure to comply with organizational formalities is a much criticized factor weighed under the corporate veil piercing standard, the legislature's efforts to ensure that failure to observe organizational formalities is not used as a basis for imposing personal liability on LLC members may implicitly recognize the possibility of otherwise applying corporate veil

38. Schwindt, *supra* note 33, at 1554.

39. *See* Sec. Investor Prot. Corp., 274 B.R. at 775 (quoting statute).

40. *Id.*; *see also* Chad Brigham, *Just How Limited is the Illinois Limited Liability Company?*, 26 S. ILL. U. L.J. 53 (2001) (arguing that the evolution of the Illinois statute history does not preclude application of veil piercing to Illinois LLCs).

41. William A. Price, *A Primer on the Amended Illinois Limited Liability Company Act*, J. OF DUPAGE COUNTY BAR ASSOC. (Nov. 1998), http://www.dcba.org/brief/novissue/1998/art11198.htm.

piercing rules to LLCs.[42] At the very least, however, the judge should have joined issue with the alternative interpretation suggested above.

C. *The Leading Case*

Appropriately enough, the leading case to undertake a substantial analysis, *Kaycee Land & Livestock v. Flahive*,[43] comes from Wyoming, the state in which the LLC was born. The Wyoming LLC statute is one of the silent statutes, providing no express authorization for courts to pierce the LLC veil. To the contrary, the statute's text seems clearly to preclude the imposition of personal liability: "Neither the members of a limited liability company nor the managers of a limited liability company managed by a manager or managers are liable under a judgment, decree or order of a court, or in any other manner, for a debt, obligation or liability of the limited liability company."[44] Not even the hedge word "solely," on which the Connecticut courts seized, appears in what looks like a flat prohibition of personal liability. Yet, the Wyoming Supreme Court concluded that the LLC veil may be pierced.[45]

This result was predetermined when the court began its analysis by immediately conflating the LLC with the corporation: "To answer this question, we must first examine the development of the doctrine within Wyoming's corporate context."[46] Apparently anticipating this move, Flahive had tried to avoid extension of the corporate doctrine to the LLC by contrasting the LLC statute to the relevant provision of the Wyoming Corporation Code: "'Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.'"[47] Flahive pointed out that the LLC statute lacks a comparable proviso for personal liability arising from a LLC member's "own acts or conduct."[48]

The court rejected this argument. At the outset of its opinion, the court noted that veil piercing evolved as an equitable doctrine.[49] In response to Flahive's argument, the court then opined that because veil

42. Robert Thompson argues that Illinois-like statutes "providing general insulation for LLC participants and then an additional provision specifying that a particular piercing doctrine such as failure to follow corporate formalities should not be used to pierce . . . support an inference that other long-developed principles of piercing law remain available for judicial use." Thompson, *supra* note 19, at 18.

43. 46 P.3d 323 (Wyo. 2002).

44. WYO. STAT. ANN. § 17-15-113 (Michie 1977).

45. *Kaycee*, 46 P.3d at 327–28.

46. *Id.* at 325.

47. *Id.* at 326 (quoting WYO. STAT. ANN. § 17-16-622(b) (LexisNexis 2001)).

48. *Id.*

49. *Id.*; *see also* Schwindt, *supra* note 33, at 1552 (opining that "[t]he paucity of statutory authority for LLC piercing should not be considered a barrier to its application. The concept of piercing the corporate veil is based on common law, rather than state or federal statutory law.") (footnotes and internal quotation marks omitted).

piercing "is an equitable doctrine" the paucity of statutory authority for piercing the LLC veil was not surprising.[50] Finally, the court invoked the hoary canon of statutory construction under which statutes in derogation of the common law are to be strictly construed.[51] Because the court saw no evidence of legislative intent to preclude application of the common law veil piercing to the LLC context, the court held that the LLC veil could be pierced.[52]

The flaws in this analysis are many and obvious. Most significantly, there was no common law of LLCs. The interpretative canon in question is invoked typically when the legislature adopts a statute in an area of the law where there is preexisting common law.[53] The LLC, however, was an entirely new statutory creation. There was no background of common law against which it was to be implemented. Corporate common law was relevant to the problem at bar only by virtue of judicial fiat.

Even if the court was correct in opining that corporate common law was relevant, its invocation of the canon in question was suspect. Karl Llewellyn famously demonstrated that canons of construction are essentially indeterminate.[54] Further, the canon requiring strict construction of statutes in derogation of the common law is particularly suspect. The canon "can work to ossify an obsolete status quo and, in any event, is probably rooted historically in a selfish desire by English judges to limit Parliament's" power.[55] The authors of the passage just quoted further opine that "the derogation canon . . . is usually treated as anathema by contemporary commentators."[56]

The *Kaycee* court concluded that it could "discern no reason, in either law or policy, to treat LLCs differently than we treat corporations."[57] Part III offers some reasons for doing just that. Ultimately, the leading case on the subject utterly failed to offer any compelling reason, in either law or policy, for treating LLCs and corporations the same.

50. *See Kaycee*, 46 P.3d at 326–27.

51. *Id.* at 327.

52. *See id.* (noting the "dearth of legislative consideration on this issue"); *see also* Bastan v. RJM & Assoc., LLC, No. CV99-0593189-S, 2001 WL 1006661, at *1 (Conn. Super. Ct. June 4, 2001) (reasoning that the "legislature is deemed to have been aware of our deeply rooted common law remedy of imposing personal liability upon a shareholder of a corporation where the corporate shield has been used to promote injustice, and the legislature surely could have expressly created a blanket limitation of member liability had it so chosen").

53. *See, e.g.*, Augusta & Savannah R.R. v. McElmurry, 24 Ga. 75, 78 (Ga. 1858) (noting that "[a]cts relative to railroads cannot be in derogation of the common law, for railroads were unknown to the common law"); *see also* Gottling v. P.R. Inc., 61 P.3d 989, 995 (Utah 2002) (declining to follow the canon where there was no relevant common law when the statute in question was enacted).

54. Karl N. Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are To Be Construed*, 3 VAND. L. REV. 395 (1950).

55. WILLIAM N. ESKRIDGE ET AL., LEGISLATION AND STATUTORY INTERPRETATION 332 (2000).

56. *Id.* at 334; *see also* Adrian Vermeule, *The Judicial Power in the State (and Federal) Courts*, 2000 SUP. CT. REV. 357, 429–30 (noting that while "[s]tate courts have often invoked the canon that statutes in derogation of the common law should be narrowly construed . . . that canon may be falling out of favor").

57. *Kaycee*, 46 P.3d at 327.

D. The Emerging Standards for Piercing the LLC Veil

Several formulations of the veil piercing standard compete in corporate law. In light of the predominant trend for courts to import the corporate law regime into the LLC context, it is not surprising that a similar multitude of standards is emerging in the latter setting.

Control is the common (if sometimes implicit) feature of all the concepts used to describe cases in which veil piercing is appropriate. LLC members who do not actively participate in the firm's business or management are rarely held liable on a veil piercing theory.[58] It seems clear therefore that control is an essential prerequisite for holding a LLC member or manager liable.

Standing alone, however, control cannot be a sufficient ground for piercing the veil of either a corporation or a LLC. Granted, *Walkovszky v. Carlton,*[59] the leading corporate law decision, indicates that veil piercing is appropriate where the corporation is "a 'dummy' for its individual shareholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends."[60] The problem with this analysis, however, is that a close corporation with, for example, one to three dominant shareholders has no "corporate ends" separate from those of its owners. In apparent recognition of this fact, courts generally require plaintiffs to show something more than mere control in the corporate law context.[61]

Courts are likewise developing multi-pronged standards for the LLC context. A common formulation, for example, asks whether the LLC member to be held personally liable (1) controlled the LLC and (2) abused his control of the firm "in order to defeat justice or perpetrate fraud."[62] Another common formulation adapts the three-pronged instrumentality doctrine used in corporate law, under which the plaintiff must show: (1) control of the corporation by the defendant that is so complete as to amount to total domination of finances, policy, and business practices such that the controlled corporation has no separate mind,

58. *See* New England Nat'l LLC v. Kabro of East Lyme LLC, No. 550014, 2000 WL 254590, at *6 (Conn. Super. Ct. Feb. 23, 2000).

59. 223 N.E.2d 6 (N.Y. 1966).

60. *Id.* at 8; *see* Franklin A. Gevurtz, *Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil*, 76 OR. L. REV. 853, 864 (1997) ("No corporation in the world has a mind of its own; they are fictitious entities. People control corporations.").

61. *See, e.g.*, Luis v. Orcutt Town Water Co., 22 Cal. Rptr. 389, 395 (Cal. Ct. App. 1962) ("It is not true that any wholly owned subsidiary is necessarily the *alter ego* of the parent corporation."); Shafford v. Otto Sales Co., 260 P.2d 269, 277 (Cal. Ct. App. 1953) ("[C]omplete stock ownership and actual one-man control will not alone be sufficient to impose liability on the individual.").

62. For example, in *Bonner v. Bruson*, 585 S.E.2d 917 (Ga. Ct. App. 2003) the court stated:

> A court may disregard the separate LLC entity and the protective veil it provides to an individual member of the LLC when that member, in order to defeat justice or perpetrate fraud, conducts his personal and LLC business as if they were one by commingling the two on an interchangeable or joint basis or confusing otherwise separate properties, records, or control.

Id. at 918; *see also* Gallinger v. N. Star Hosp. Mut. Assurance, Ltd., 64 F.3d 422, 427 (8th Cir. 1995) (adopting similar two-pronged standard).

will, or existence; (2) such control is used to commit a fraud, wrong, or other violation of the plaintiff's rights; and (3) the control and breach of duty owed to the plaintiff was a proximate cause of the injury.[63]

As with corporate law cases,[64] the analysis in LLC litigation frequently collapses into a mere laundry list of factors considered by the court.[65] In *Bonner v. Bruson*,[66] for example, the Georgia Court of Appeals set out its "defeat justice or perpetrate fraud" standard, but then ignored that standard to focus on various specific transactions to determine whether there was "any evidence that [defendant] Bruson abused the form of the LLC by commingling or confusing LLC business with his personal affairs."[67]

The *Bonner* decision is particularly troubling because the Georgia court seemingly imported into the LLC context not only the corporate veil piercing doctrine, but also the fetish for formalities so often found in corporate veil piercing cases.[68] We shall see below that limited liability is a social concern mainly because it permits equity investors to externalize risk.[69] As such, failure to observe organizational formalities is largely irrelevant. Setting aside the rare cases in which failure to observe organizational formalities misleads a creditor into believing it is dealing with an individual rather than a LLC, there simply is no causal link between the creditor's injury and the member's misconduct.

The drafters of the ULLCA recognized the desirability of moving away from an emphasis on compliance with formalities by providing, in section 303(b), that:

> The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.[70]

So too did the *Kaycee* court, which noted that because the LLC is intended to be "much more flexible" in operation than corporations, the

63. *See, e.g.*, Zaist v. Olson, 227 A.2d 552, 558 (Conn. 1967); Collet v. Am. Nat'l Stores, Inc., 708 S.W.2d 273, 284 (Mo. Ct. App. 1986). A number of decisions, especially in Connecticut, have extended the instrumentality rule to the LLC setting. *See, e.g.*, Stone v. Frederick Hobby Assoc. II, No. CV0001816205, 2001 WL 861822 (Conn. Super. Ct. July 10, 2001); Bastan v. RJM & Assoc., LLC, No. CV99-0593189-S, 2001 WL 1006661 (Conn. Super. Ct. June 4, 2001); Rafferty v. Noto Bros. Constr., LLC, No. CV000082596, 2001 WL 459073 (Conn. Super. Ct. Apr. 17, 2001).

64. *See* BAINBRIDGE, *supra* note 16, at 157–61 (discussing judicial reliance on a "laundry list" of factors in corporation law).

65. *See generally* Eric Fox, Note, *Piercing the Veil of Limited Liability Companies,* 62 GEO. WASH. L. REV. 1143, 1167–77 (1994) (setting out a list of potentially relevant factors and arguing that the relevance of any given factor will depend on the extent to which the LLC's governance and financial structures resemble those of a corporation or an unincorporated firm).

66. *Bonner*, 585 S.E.2d 917.

67. *Id.* at 919.

68. *Cf.* BAINBRIDGE, *supra* note 16, at 159–61 (criticizing the emphasis on compliance with corporate formalities in veil piercing decisions in corporation law).

69. *See infra* Part III.A.2.

70. UNIF. LTD. LIAB. CO. ACT § 303(b), 6A U.L.A. 590 (2003).

standard for piercing the LLC veil should not emphasize disregard for operational formalities to the extent that the corporate law version does.[71] Unfortunately, as *Bonner* illustrates, not all courts are getting it right; instead, these courts are importing corporate law's insistence on compliance with organizational formalities into the LLC context.[72]

Stone v. Frederick Hobby Associates II,[73] decided under Connecticut's instrumentality standard, provides a particularly egregious example of this trend. As is often the case with the instrumentality standard,[74] the court's analysis of the second prong—i.e., the requirement of a showing that "the defendant [exerted such complete control over the corporate entity so as to enable him] to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest or unjust act in contravention of plaintiff's legal rights"[75]—ranged from perfunctory to muddled. The court placed great emphasis on the defendant's failure to follow corporate formalities.[76] The court took the defendants to task, for example, for failing to properly fill out a real estate conveyance tax return.[77] In response to a question asking whether the grantor was a LLC, the principal defendant checked the "no" box.[78] The principal defendant also signed the return in his individual capacity.[79] But who cares?[80] There was no evidence that these errors harmed anybody.

71. Kaycee Land & Livestock v. Flahire, 46 P.3d 323, 328 (Wyo. 2002); *see also* Hollowell v. Orleans Reg'l Hosp. LLC, No. Civ.A. 95-4029, 1998 WL 283298, at *9 (E.D. La. May 29, 1998) (stating that "analyses between corporate veil piercing and limited liability company veil piercing may not completely overlap . . . '[b]ecause the Louisiana LLC law requires fewer formalities'" than does corporate law), *aff'd,* 217 F.3d 379 (5th Cir. 2000). Commentators uniformly support deemphasizing organizational formalities in the LLC context. *See, e.g.*, Fox, *supra* note 65, at 1172; Ribstein, *Emergence, supra* note 7, at 9.

72. *See, e.g.*, Lincoln Diversified Sys., Inc. v. Mangos Plus, Inc., No. 98 CIV. 5593 (RWS), 2000 WL 1880338 (S.D.N.Y. Dec. 27, 2000) (citing lack of evidence that formalities were ignored in explaining its refusal to pierce); Litchfield Asset Mgmt. Corp. v. Howell, 799 A.2d 298, 315–16 (Conn. App. Ct. 2002) (discussing defendant's failure to observe formalities); Stone v. Frederick Hobby Assoc. II, No. CV000181620S, 2001 WL 861822, at *10 (Conn. Super. Ct. July 10, 2001) (piercing the corporate veil on grounds, inter alia*,* that defendants "affirmatively acted with disregard for Hobby II's existence as an entity that is separate and distinct"); Hamilton v. AAI Ventures, LLC, 768 So. 2d 298, 302 (La. Ct. App. 2000) (invoking corporate standard of "failing to follow statutory formalities for incorporating and transacting corporate affairs" in LLC setting); Advanced Tel. Sys. Inc. v. Com-Net Prof'l Mobile Radio LLC, 59 Pa. D. & C.4th 286, 305 (Pa. C.P. 2002) (citing the absence of evidence that "necessary formalities [were] ignored").

73. *Stone*, 2001 WL 861822.

74. *See* BAINBRIDGE, *supra* note 16, at 153–54 (discussing a leading instrumentality standard precedent).

75. *Stone*, 2001 WL 861822, at *8.

76. *See id.* at *10 (discussing omitted formalities).

77. *Id.*

78. *Id.*

79. *Id.*

80. Setting aside the fact that disregard for formalities should be given less weight in the LLC setting, disregard for entity formalities is more directly relevant to the first prong of the instrumentality standard—i.e., whether the defendant treated the firm as his alter ego—than the second. *See* BAINBRIDGE, *supra* note 16, at 153–54 (discussing application of the instrumentality standard). Relying on the LLC member's disregard for organizational formalities as a justification for veil piercing is

Aside from the defendants' disregard for organizational formalities, the *Stone* court noted testimony indicating that the LLC was set up "to shield and protect . . . the principals of Hobby II, from personal liability."[81] Granted, some of the defendants were overly colorful—even flippant—in their attitude. Defendants' legal counsel, for example, "told the plaintiffs to 'go ahead and sue [Hobby II]. There is no money in [Hobby II]. Why do you think we set it up as an LLC in the first place?'"[82] But so what? First, setting up a limited liability entity to shield oneself from personal liability is not a fraud or wrong. To the contrary, corporate law expressly "permits the incorporation of a business for the very purpose of escaping personal liability."[83] Presumably, LLC law should do likewise.[84] Second, to the extent the lack of resources in the *Hobby II* LLC troubled the court, undercapitalization alone is not a sufficient basis for piercing the veil in corporate law.[85] Again, the same should be true in LLC law.

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particularly problematic on *Stone*'s facts because it was a contract case. *See id.* at 160–61 (arguing that whether defendant complied with organizational formalities is especially irrelevant when the claim sounds in contract).

81. *Stone*, 2001 WL 861822, at *9.

82. *Id.*

83. Bartle v. Home Owners Coop., Inc., 127 N.E.2d 832, 833 (N.Y. 1955); *see also* Northern Tankers (Cyprus) Ltd. v. Backstrom, 967 F. Supp. 1391, 1402 (D. Conn. 1997) (holding that "the corporate fiction is generally recognized, even when set up for the very purpose of avoiding personal liability," albeit as a matter of federal common law rather than that of Connecticut).

84. The *Stone* court opined that the misconduct required by the second prong may be found "even in the absence of fraud or illegality, when the individual in control has, for example, used a corporate instrumentality to avoid personal liability that he had previously assumed." *Stone*, 2001 WL 861822, at *8. Even if correct, however, this rule on its face applies only where the corporate (or LLC) form is used to evade a pre-existing obligation. On the facts of *Stone*, there was no such obligation. The original contract was made between plaintiffs and the Hobby II LLC. *See id.* at *1 (noting that "the plaintiffs allege that: they purchased the premises from the defendant, Hobby II.").

This error has cropped up in other Connecticut trial court decisions. In *KLM Indus., Inc. v. Tylutki*, No. CV980062008S, 2001 WL 1098069 (Conn. Super. Ct. Aug. 23, 2001), for example, the court pierced the LLC veil where the alleged wrong committed was an effort "to frustrate the payment of a lawful debt." *Id.* at *5 This holding is clearly erroneous. In *Campisano v. Nardi*, 562 A.2d 1 (Conn. 1989), the Connecticut Supreme Court made clear that courts should decline "to apply the instrumentality rule where the corporations were formed for legitimate purposes and the parties engaging in transactions with those corporations were fully aware of the type of business with which they were dealing. In the absence of a claim that the corporation was formed for an improper purpose, or that the plaintiffs were improperly induced to enter into a contract with the corporation, the mere breach of a corporate contract cannot of itself establish the basis for application of the instrumentality rule." *Id.* at 7 (footnote omitted).

85. *See, e.g.*, Gartner v. Snyder, 607 F.2d 582, 588 (2d Cir. 1979) ("Although Enterprises was thinly capitalized, that alone is not a sufficient ground for disregarding the corporate form. We know of no New York authority that disregards corporate form solely because of inadequate capitalization."). The case usually cited for the proposition that undercapitalization alone suffices, *Minton v. Cavaney*, 364 P.2d 473 (Cal. 1961), arguably does not in fact stand for that proposition and, in any event, probably is no longer good law even in its home jurisdiction. *See, e.g.*, Arnold v. Browne, 103 Cal. Rptr. 775, 783 (Cal. Ct. App. 1972) (treating undercapitalization as merely a relevant, but not dispositive, factor); Harris v. Curtis, 87 Cal. Rptr. 614, 617 (Cal. Ct. App. 1970) (rejecting argument "that, per se, inadequate capitalization renders the shareholders . . . liable for the obligations of the corporation.").

E. Enterprise Liability Involving LLCs

Veil piercing-like issues are frequently presented in cases involving groups of affiliated corporations, including those involving parent and subsidiary corporations. In the leading corporate law decision, *Walkovszky v. Carlton*,[86] the defendant was the principal shareholder of a number of corporations operating taxicabs. The plaintiff, who had been injured by a cab owned by one of those companies, claimed that the multiple corporations had no separate existence, but rather were just components of a single business enterprise.[87] The court held that the corporate veil may not be pierced simply because the defendant corporation is part of a larger enterprise.[88] Instead, proof that multiple corporations are part of a single corporate group may give rise to enterprise liability.[89]

If correctly (and successfully) invoked, enterprise liability permits a creditor to reach the collective assets of all of the corporations making up the enterprise.[90] Obviously, this theory is most useful when the responsible corporation is insolvent, but the enterprise as a whole has sufficient assets to satisfy the creditor's claim. Given that enterprise liability is well-established in corporate law,[91] and that borrowing from corporate law is a well-established pattern in LLC cases, it comes as no surprise that courts are extending enterprise liability to corporate groups including LLCs.[92]

F. Summation

Benjamin Cardozo long ago observed that veil piercing is a doctrine "enveloped in the mists of metaphor,"[93] a complaint that remains true today. On the one hand, corporate veil piercing cases are highly fact-specific.[94] On the other hand, the facts often tell us little about the likely outcome. Successful corporate veil piercing claims seem to differ only in degree, but not in kind, from unsuccessful claims.[95] Unfortunately, there

86. 223 N.E.2d 6 (N.Y. 1966).

87. *Id.* at 7.

88. *Id.* at 9.

89. *See id.* at 8

90. *See id.*

91. *See, e.g.*, Gartner v. Snyder, 607 F.2d 582, 588 (2d Cir. 1979); Las Palmas Assocs. v. Las Palmas Ctr. Assocs., 235 Cal. App. 3d 1220, 1250 (1991).

92. *See, e.g.*, Litchfield Asset Mgmt. Corp. v. Howell, 799 A.2d 298, 315–16 (Conn. App. Ct. 2002).

93. Berkey v. Third Ave. Ry. Co., 155 N.E. 58, 61 (N.Y. 1926).

94. In corporation law, veil piercing claims are treated as pure questions of fact. Accordingly, appellate courts generally defer to the trier of fact and reverse only for abuse of discretion. *See* Stark v. Coker, 129 P.2d 390 (Cal. 1942). As the California Supreme Court acknowledged, this standard means that appellate opinions typically provide only "general rules" for guidance. *Id.* at 394. There is nothing to suggest that those principles will change in the LLC context.

95. *See generally* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991) (providing a detailed empirical analysis of factors considered in both successful and unsuccessful piercing cases).

is no evidence to date that matters will improve as the vague corporate law standards are exported to the LLC setting.

III. POLICY

In the leading *Kaycee* decision, the Wyoming Supreme Court concluded: "We can discern no reason, in either law or policy, to treat LLCs differently than we treat corporations."[96] Admittedly, there is a certain intuitive logic to treating LLCs the same way we do corporations. Even so, however, why privilege the assumption that corporations and LLCs are to be treated the same?

Granted, there is little direct evidence that legislatures intended to treat LLCs and corporations differently.[97] Yet, if legislatures had intended to incorporate the corporate law doctrines, they easily could have done so explicitly. Indeed, as we have seen, Minnesota did exactly that.[98] So did a number of other early LLC statutes.[99] Given the ready availability of such models, one could infer that subsequently adopted statutes were not intended to incorporate corporate law rules in the absence of explicit Minnesota-like language. As we have seen, this argument is especially compelling for states like Illinois, which moved away from a Minnesota-like formulation to a more neutral model that neither expressly nor impliedly invokes corporation law's veil piercing rules.[100]

In the absence of dispositive evidence of legislative intent, however, we now turn to the second prong of the *Kaycee* court's pronouncement. Is there good "reason, in . . . policy, to treat LLCs differently than we treat corporations?"[101] In an ideal world, at least as defined by my policy preferences, we would treat them the same by abolishing veil piercing as to both. Assuming veil piercing will remain the law as to corporations, however, it is my thesis herein that we should treat LLCs differently by abolishing veil piercing as to them.

96. Kaycee Land & Livestock v. Flahive, 46 P.3d 323, 327 (Wyo. 2002). Many commentators likewise privilege the assumption that LLCs and corporations are to be treated the same. *See, e.g.*, Schwindt, *supra* note 33, at 1551–52 (opining that: "Given that corporations and limited partnerships both provide exceptions to the general rule of limited liability, it seems unlikely that LLCs would not also be subject to an exception that would expose their members to personal liability in certain instances."); Thompson, *supra* note 19, at 20 (arguing that courts are unlikely to read LLC statutes as providing "greater insulation than corporate law" "given the long-standing common law in this area" and the lack of clear legislative intent).

97. *See, e.g.*, Thompson, *supra* note 19, at 21 (arguing that LLC statutes "do little, if anything, to change the long-standing and well-developed judicial exceptions to limited liability"); *cf.* Schwindt, *supra* note 33, at 1552 (arguing that: "In the absence of statutory authority, courts should strive to develop a common law LLC piercing doctrine just as one was developed in the corporate setting.").

98. *See supra* note 20 and accompanying text.

99. *See* Fox, *supra* note 65, at 1168 (stating that "Colorado specifically calls for the application of the veil-piercing doctrine to LLCs"); Thompson, *supra* note 19, at 17 (listing California, Hawaii, Minnesota, North Dakota, Wisconsin, and Washington as having statutes that "specify that corporate law principles should be used to pierce the veil generally").

100. *See supra* notes 36–42 and accompanying text.

101. *Kaycee*, 46 P.3d at 327.

A. The Case for Veil Piercing

It is surprisingly difficult to find coherent explanations of the policy justifications for piercing the LLC veil, as opposed to mere assertions by fiat that such reasons exist. Two explanations tend to crop up most frequently. One depends on a notion of corporate personhood and can be dismissed almost out of hand. The other views limited liability as creating a negative externalities-based market failure. That view is true, but proves too much.

1. The Entity as Separate Person

In *Kaycee*, the Wyoming Supreme Court treated veil piercing as a corollary of the corporation's status as a legal person:

> Statutes created the legal fiction of the corporation being a completely separate entity which could act independently from individual persons. If the corporation were created and operated in conformance with the statutory requirements, the law would treat it as a separate entity and shelter the individual shareholders from any liability caused by corporate action, thereby encouraging investment. However, courts throughout the country have consistently recognized certain unjust circumstances can arise if immunity from liability shelters those who have failed to operate a corporation as a separate entity. Consequently, when corporations fail to follow the statutorily mandated formalities, co-mingle funds, or ignore the restrictions in their articles of incorporation regarding separate treatment of corporate property, the courts deem it appropriate to disregard the separate identity and do not permit shareholders to be sheltered from liability to third parties for damages caused by the corporations' acts.
>
> . . . If the members and officers of an LLC fail to treat it as a separate entity as contemplated by statute, they should not enjoy immunity from individual liability for the LLC's acts that cause damage to third parties.[102]

To be sure, the law treats corporations and LLCs as legal persons separate from their shareholders or members (as the case may be).[103] The entity's legal personhood, moreover, has important real world consequences.[104] Even so, status as a separate legal person is but a convenient legal fiction.[105]

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102. *Id*.

103. Puerto Rico v. Russell & Co., 288 U.S. 476, 479 (1933) (noting "the complete legal personality with which corporations are endowed").

104. Corporate constituents contract not with each other, for example, but with the corporation. A bond indenture thus is a contract between the corporation and its creditors, an employment agreement is a contract between the corporation and its workers, and a collective bargaining agreement is a contract between the corporation and the union representing its workers. *See, e.g.*, John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543, 550 (1964) (collective bargaining agreement); Berman v. Physi-

In the present context, the legal fiction that the LLC is a separate entity belies actual practice. A close corporation with a few dominant shareholders has no interests or purposes separate and distinct from those of its shareholders. The same is true of a LLC. To insist to the contrary is simply mindless formalism.

As I have explained elsewhere in more detail, moreover, reifying the firm as a separate entity is inconsistent with the prevailing understanding of the corporation as a nexus of contracts.[106] In this model, the firm is viewed not as an entity separate from its shareholders and other stakeholders, but rather as the nexus of a complex set of contractual relationships between many stakeholders who provide inputs for the corporation's productive processes. In the LLC setting, just as in the close corporation setting, all of these stakeholders know (or should know) that it is those who contribute equity capital that are vested with the power to control the enterprise. They should not be surprised that the equity claimants often blur the distinction between the business of the firm and their personal affairs. At least in the absence of proof that such a blurring of the boundary between the entity and the equity claimants caused injury to another stakeholder, there is no justification whatsoever for judicial intervention. The *Kaycee* court's apparent insistence to the contrary simply cannot be justified.

2. The Negative Externalities of Limited Liability

An alternative judicial explanation for veil piercing asserts that courts should pierce the veil when "the policy behind the presumption of corporate independence and limited shareholder liability—encouragement of business development—is outweighed by the policy justifying disregarding the corporate form—the need to protect those

cal Med. Assocs., 225 F.3d 429, 433 (4th Cir. 2000) (employment agreement); Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3d. Cir. 1993) (bond). If the contract is breached on the corporate side, it will be the entity that is sued in most cases, rather than the individuals who decided not to perform. If the entity loses, damages typically will be paid out of its assets and earnings rather than out of those individuals' pockets.

105. *Cf.* Citizens Coordinating Comm. on Friendship Heights, Inc. v. Wash. Metro. Area Transit Auth., 765 F.2d 1169, 1173 (D.C. Cir. 1985) (holding that: "Though a corporation is a person for some purposes, we would be most reluctant to hold that it has senses and so can be affronted by deteriorations in its environment. That is beyond the reach of legal fiction and belongs in the realm of poetic license.").

106. Bainbridge, *supra* note 1, at 484–86. The nexus of contract model's dominance within corporate law scholarship has been widely recognized by diverse jurists and scholars, including some who are not enthusiasts of the genre. *See, e.g.*, William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1399 (1993) (former Delaware Chancellor); Brian R. Cheffins, *Using Theory to Study Law: A Company Law Perspective*, 58 CAMBRIDGE L.J. 197, 209 (1999) ("[O]ne school of thought, law and economics, dominates the academic study of corporate law."); Joel Seligman, *Foreword* to PROGRESSIVE CORPORATE LAW ix, ix (Lawrence E. Mitchell ed., 1995) ("[T]he dominant recent analytical tool for corporate law analysis has been neoclassical economics . . . with its by now familiar subtexts of market imperfections, agency costs, and nexus of contracts . . . .").

who deal with the corporation."[107] Clearly, however, not all those who deal with the corporation will receive this protection. As one court opined, "some 'wrong' beyond a creditor's inability to collect" must be shown before the veil will be pierced.[108] What then is the harm against which veil piercing protects those who deal with the corporation? And, does the same harm apply to LLCs?

It is generally accepted that limited liability creates negative externalities.[109] Limited liability allows equity holders to cause the firm to externalize part of the risks and costs of doing business onto other constituencies of the firm and, perhaps, even onto society at large.[110] The point is too well-established to require elaboration. Yet, externalities provide a foundation of sand for the complex edifice of modern veil piercing law.

a. The Argument from Negative Externalities Does Not Justify the Veil Piercing Doctrine

First, the externalities argument proves too much. Indeed, it makes a better justification for repealing the general rule of limited liability than it does for carving out a veil piercing-based exception to the general rule. Professors Hansmann and Kraakman, in fact, famously invoked the externalities argument to justify their proposal that limited liability should be eliminated with respect to tort claims.[111] Their argument has been criticized by a number of commentators.[112] In lieu of rehashing those arguments, it suffices for present purposes to note that their proposal has not been embraced by either legislatures or courts.[113] To the contrary, "states have been busily expanding the scope of limited liability through the creation of such new enterprise forms as limited liability companies and limited liability partnerships."[114]

107. Wm. Passalacqua Builders, Inc. v. Resnick Developers South, Inc., 933 F.2d 131, 139 (2d Cir. 1991).

108. Sea-Land Services, Inc. v. Pepper Source, 941 F.2d 519, 524 (7th Cir. 1991).

109. *See, e.g.*, Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. LAW 573, 576 (1986) (stating that "even economists convinced of the utility of limited liability . . . concede that limited liability raises serious problems because it enables the enterprise to externalize its costs"); Easterbrook & Fischel, *supra* note 4, at 104 (explaining that "shareholders of a firm reap all of the benefits of risky activities but do not bear all of the costs"); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1586 (1991) (asserting that "[l]imited liability does not simply offset positive externalities, but rather encourages excessively risky activity").

110. *See generally* BAINBRIDGE, *supra* note 16, at 132–34 (explaining how limited liability does so).

111. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

112. *See, e.g.*, MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 56 (1995); Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens,* 106 HARV. L. REV. 387 (1992); Bainbridge, *supra* note 1, at 496–500; Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387 (1992).

113. *See* Bainbridge, *supra* note 1, at 500 (noting that "no state has repealed limited liability for mass torts or, indeed, torts of any kind").

114. *Id.*

Second, there is no reason to believe that veil piercing causes equity claimants to internalize the risks associated with their business' operations. Both in rhetoric and application, the doctrine focuses on such irrelevancies as observation of organizational formalities and not on whether the equity claimants used their control to externalize risk. After all, it is clear that courts will not pierce the veil whenever the defendant externalized some costs onto third parties. As the leading *Kaycee* decision opined, for example, courts will only impose personal liability on the members of a LLC when they "fail to treat it as a separate entity as contemplated by statute."[115]

It seems unlikely that veil piercing even inadvertently addresses concerns over negative externalities. As our review of the doctrine demonstrated, the law of veil piercing is remarkably vague. Indeed, the doctrine is nothing more than analysis by epithet.[116] As a result, application of the doctrine is rare, unprincipled, and arbitrary.[117] Although there are hundreds of thousands of closely held corporations in the United States, according to the leading empirical survey there were only 226 veil piercing cases brought by tort claimants that were reported in Westlaw's various databases through 1985.[118] In only seventy of those did the court pierce the veil.[119] Assuming comparable results for LLCs, the members of a LLC have a far greater chance of being struck by lightning than being held personally liable for their firm's debts and other obligations.

Equity claimants of a limited liability entity, moreover, can very effectively insulate themselves from veil piercing-based personal liability by complying with minimal organizational formalities and providing modest levels of capital and/or insurance.[120] How can such a dysfunctional doctrine possibly create appropriate incentives for the equity claimants of either a corporation or LLC to optimally internalize the social costs of their business activities?

A particularly instructive example of the disconnect between veil piercing law and policy is provided by the treatment of contract claims. There is no externality with respect to parties who voluntarily contract with a limited liability entity.[121] Voluntary creditors can require LLC members to provide a personal guarantee of corporate debts.[122] Where a contract creditor fails to bargain around the limited liability default rule,

115. Kaycee Land & Livestock v. Flahive, 46 P.3d 323, 327 (Wyo. 2002).

116. *See* PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 8 (1983) (arguing that veil piercing law amounts to "metaphor or epithet").

117. *See supra* note 4 and accompanying text.

118. Thompson, *supra* note 95, at 1058 tbl.9.

119. *Id.*

120. *See generally* Bainbridge, *supra* note 1, at 513–14 (discussing transactional planning implications of veil piercing).

121. Easterbrook & Fischel, *supra* note 4, at 104.

122. *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 142 (8th ed. 2002).

there is no justification for giving it a second bite at the apple through a veil piercing remedy. At the very least, veil piercing should be limited to cases in which misrepresentations induced the voluntary creditor to do business with the entity without demanding a personal guarantee or where the LLC members subsequently siphoned funds out of the entity through fraudulent transfers.

Based on this analysis one would expect to find fewer contract than tort veil piercing cases and, moreover, that the rate at which courts pierce the corporate veil would be lower in contract than tort cases. In fact, however, the leading empirical study of veil piercing cases not only found that veil piercing claims by contract creditors are more frequent than by tort creditors, but also that contract creditors are more likely to prevail than tort creditors.[123] One can finesse one's way around this result,[124] but there is no denying the disconnect between law and theory.

b. Why Abolition Is Preferable to Reform

Could veil piercing be reformed, so as to mend it but not end it? Perhaps veil piercing could be refocused so as to eliminate irrelevancies and be tied more closely to the policy purposes it is intended to effectuate. To answer that question, we must first consider the reasons the veil piercing doctrine is so dysfunctional today.

Determining the availability of limited liability on a case-by-case basis requires courts to balance a number of competing policy considerations. On the one hand, the court must encourage businesses to optimally internalize the costs to society of their activities.[125] On the other hand, courts wish to avoid impeding capital formation and economic growth.[126] Balancing these concerns would require tricky economic analysis, but courts have no staff economists.[127]

Generalist judges left to their own devices are hardly likely to strike the correct balance.[128] First, judges are not exempt from the cognitive limitations the theory of bounded rationality suggests afflict all decision

123. Thompson, *supra* note 95, at 1058 (finding 779 contract veil piercing cases versus only 226 tort claims; contract creditor success rate of forty-two percent versus tort creditor success rate of thirty-one percent).

124. *See, e.g.*, DOOLEY, *supra* note 112, at 65 (noting that many contract cases likely involve active misconduct by the shareholder affording grounds for direct liability).

125. *See* Bainbridge, *supra* note 1, at 506.

126. *See supra* text accompanying note 3.

127. *Cf.* Basic Inc. v. Levinson, 485 U.S. 224, 253 (1988) (White, J., dissenting) (observing that "with no staff economists, no experts schooled in the 'efficient-capital-market hypothesis,' no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.").

128. The analysis in this section draws on Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 146–48 (2002).

makers.[129] Like all humans, judges have inherently limited memories, computational skills, and other mental tools.[130] Second, judges function under severe time and resource constraints.[131] As a result, judicial decision making is subject to "significant institutional constraints providing further incentives for judges to minimize effort."[132] Third, state court judges (outside Delaware) rarely come to the bench with significant corporate law expertise. State judges likely do not have much interest in developing substantial expertise in this area after they arrive or any incentive to do so, because (outside Delaware) corporate law cases are handled by courts of general civil jurisdiction whose judges decide corporate law issues only episodically. This assumption is confirmed by a study finding that judges who decide consumer credit cases frequently do not even understand the rather basic concept of present value.[133]

Under such conditions, judges would likely seek ways of deciding these cases with minimal effort. A basic way of economizing on limited cognitive resources is to invoke shortcuts—i.e., heuristic problem-solving decision making processes. On the one hand, the shortcut allows the judge to dispose of the case summarily without dealing with time- and resource-consuming complexities. On the other hand, provided the shortcut is well-accepted, it provides a doctrinally plausible ground for dismissing the case, so the judge is insulated from injury to his or her reputation or self-esteem. When judges rely on shortcuts, however, the result often is skewed and mediocre doctrine.[134]

This pattern, of course, is precisely what we observe in the veil piercing area. Courts rarely, if ever, engage in sophisticated analysis of whether the shareholder used the shield of limited liability to externalize risks. Instead, veil piercing opinions fairly can be characterized as analysis by epithet.[135] Courts may well have a vague intuitive sense of what constitutes an appropriate outcome, but, if so, they seem unable to articulate it. Instead of reasoned analysis, courts typically tack on vague labels such as "alter ego" or "lack of separation,"[136] which amount to mere conclusory announcements of result—in other words, heuristics. Or, in a different manifestation of the heuristic phenomenon, the courts turn to multi-factor tests even though they appear to have little under-

129. *See* HERBERT A. SIMON, *Rational Choice in the Structure of the Environment*, in MODELS OF MAN 261, 271 (1957) (developing the concept of bounded rationality).

130. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477 (1998) (identifying such limits).

131. Bainbridge & Gulati, *supra* note 128, at 85 n.2.

132. *See id.* at 100–05 (discussing incentive effects of constraints on judges).

133. Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 758 (2000).

134. Bainbridge & Gulati, *supra* note 128, at 137.

135. *See supra* note 116 and accompanying text.

136. *See* BLUMBERG, *supra* note 116, at 8.

standing of why the factors matter (other than the fact that some other court used them).[137]

Given the incentives judges face in the class of cases currently covered by the veil piercing doctrine, it seems highly unlikely that reform will produce any significant improvement on present results. Instead, as I have argued elsewhere: "Abolishing veil piercing is thus a necessary step to redirecting judicial incentives towards the correct set of solutions to the problem."[138]

c. The Impact of Abolition on the Negative Externalities Created by Limited Liability

Abolishing veil piercing would not give businesses a license to externalize risk. First, market forces significantly constrain the ability so to do. Granted, limited liability appears to make the LLC a far more attractive choice than the partnership, because equity claimants in the former do not bear the entirety of firm debts and obligations in the way that partners do. On closer examination, however, the advantage of limited liability is easily overstated. As already noted, for example, many contract creditors insist that shareholders of a closely-held corporation or members of a LLC guarantee the firm's debts.[139] In addition, the need to preserve their business as a going concern provides incentives for LLC members to ensure that the firm maintains adequate capital reserves and insurance despite their limited personal liability.[140]

Second, the important category of cases in which a LLC's members externalize business risks through personal misconduct remains subject to sanction under a number of legal regimes. In many nominally piercing cases, the plaintiff could have brought a direct action against the shareholder. In numerous cases, for example, the individual defendant said or did something that misled the creditor.[141] In others, the individual defendant could be held liable either as a joint tortfeasor with the corporate

137. *See id.* at 10–12.

138. Bainbridge, *supra* note 1, at 523. John Matheson and Raymond Eby have likewise argued that the veil piercing doctrine is dysfunctional. Instead of advocating abolition of the veil piercing doctrines, however, they have merely advocated its reform. Under their proposed reform statute, however, limited liability would be set aside only where the controlling member committed fraud, transferred firm assets in exchange for less than reasonably equivalent value, or distributed firm property to a member such that the entity was rendered insolvent. John H. Matheson & Raymond B. Eby, *The Doctrine of Piercing the Veil in an Era of Multiple Limited Liability Entities: An Opportunity to Codify the Test for Waiving Owners' Limited-Liability Protection*, 75 WASH. L. REV. 147, 182 (2000). Because all three criteria involve personal misconduct by the controlling member, the differences in our approaches may be mainly semantic.

139. *See supra* note 122 and accompanying text.

140. *See* PRESSER, *supra* note 15, § 1:7, at 1-39 to -40 (noting that shareholders, in making an investment decision, are influenced by the amount or character of an entity's capitalization or by the insurance it possesses).

141. Gevurtz, *supra* note 60, at 870.

defendant or on a vicarious liability theory.[142] Because these examples capture the cases in which limited liability seems most problematic—namely, misrepresentation in connection with contract claims and deliberate externalization of unreasonable risks in tort cases—abolishing veil piercing would not leave deserving creditors without a remedy.[143]

Finally, in evaluating the externalities-based justification for veil piercing, context is critical. Modern industrial enterprises can do harm on a vast scale. At the same time, the emergence of mass tort litigation means that such enterprises face unprecedented potential liability. In recent years, numerous public corporations have been hit with multi-billion dollar lawsuits, which forced some of them into bankruptcy. Claims have ranged from products liability, such as those at issue in the Dalkon Shield[144] and breast implant litigation,[145] to environmental, such as those portrayed in *A Civil Action*,[146] to class action discrimination suits. Yet, even though many of the firms involved went through bankruptcy reorganizations, in none of these cases were their shareholders held personally liable for the firm's tortious conduct.

It was concern with precisely this class of cases that motivated Hansmann and Kraakman's proposal to eliminate limited liability with respect to tort claims: "Changes in technology, knowledge, liability rules, and procedures for mass tort litigation have for the first time raised the prospect of tort claims that exceed the net worth of even very large corporations."[147] In evaluating my competing proposal to abolish veil piercing with respect to LLCs, however, it is necessary to banish this specter from one's mind. With one important exception discussed below, mass torts and veil piercing simply do not coincide. The appropriate mental image is not Union Carbide's Bhopal disaster, to which so many critics of limited liability point,[148] but rather Walkovszky's injury at the hands of Carlton's driver.

Framing the issue in this manner facilitates cost-benefit analysis. As we have seen, veil piercing has real costs. Ex ante, investors are denied

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142. *See id*. (citing the example of *Western Rock Co. v. Davis*, 432 S.W.2d 555 (Tex. Civ. App. 1968), in which the individual defendants ordered corporate blasting despite knowing that it was damaging plaintiff's property).

143. *See generally* Bainbridge, *supra* note 1, at 514–26 (demonstrating at length that direct liability under rules sanctioning personal misconduct offers a more workable standard than does veil piercing).

144. *See generally* RICHARD B. SOBOL, BENDING THE LAW: THE STORY OF THE DALKON SHIELD BANKRUPTCY (1991).

145. *See generally* John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1343, 1404–10 (1995).

146. JONATHAN HARR, A CIVIL ACTION (1995) (describing litigation against a chemical company charged with contaminating the water table in Woburn, Massachusetts).

147. Hansmann & Kraakman, *supra* note 111, at 1880. Hansmann and Kraakman also note that firms have sought to evade tort liability through business reorganizations, such as putting hazardous activities in separate subsidiaries. *Id.* at 1881. To the extent this is a problem, however, it is better addressed through proper application of the enterprise liability remedy than through general abolition of limited liability.

148. *See, e.g.*, Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1414–15, 1419–20 (1993).

certainty and predictability. Some investors will over-invest in expensive precautions, while others will under-invest in insurance and risk reduction. Ex post, the vague veil piercing standards lead to expensive litigation and, not infrequently, erroneous results.

Admittedly, there is one situation in which mass tort liability could be externalized. That situation is dealt with via veil piercing under current law—namely, the allocation of liability within corporate groups. Some legal scholars argue that courts should be more willing to pierce the corporate veil in the parent-subsidiary context than with respect to an individual shareholder.[149] The point is well-taken. The considerations justifying limited liability insofar as individual shareholders are concerned are far less powerful when applied to corporate shareholders.[150] Introducing LLCs into the mix as either parent or subsidiary does not change the result.

In contrast to the veil piercing-based approach, however, I have argued that analytical clarity would be furthered by treating the allocation of liability within corporate groups as a variant of enterprise liability rather than as a species of veil piercing.[151] Doing so would acknowledge that the issue in the parent-subsidiary context is whether the firm has split up a single business enterprise into multiple corporations with the goal of externalizing specific risks. To say that a subsidiary is a parent corporation's alter ego and that the parent is therefore liable for the subsidiary's obligations, after all, differs only semantically from saying that the parent and its subsidiary are a single business enterprise. In either case, a successful plaintiff will be able to reach the combined assets of parent and subsidiary.[152] Put another way, in the corporate group context, what has been labeled "veil piercing" has been, in substance, enter-

149. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 56 (1991) (arguing that a court's "greater willingness to allow creditors to reach the assets of corporate as opposed to personal shareholders is . . . consistent with economic principles"). Admittedly, there seems to be little support in the case law for that proposition. *See* United States v. Bestfoods, 524 U.S. 51, 61–62 (1998) (citing numerous authorities for the "bedrock" proposition that parent corporations generally are not liable for a subsidiary's acts or debts). In fact, courts are somewhat less likely to pierce the veil of a subsidiary to reach a defendant parent corporation than when the defendant was an individual. Thompson, *supra* note 95, at 1055 tbl.7.

150. Jonathan Landers has argued that subsidiaries are run for the benefit of their parent corporations, "not with a view to ensuring that the subsidiary will function as a viable corporate entity." Jonathan M. Landers, *A Unified Approach to the Parent, Subsidiary, and Affiliate Question in Bankruptcy*, 42 U. CHI. L. REV. 589, 599 (1975). Hence, he criticizes courts for treating enterprise liability "as an offshoot of the problem of piercing the corporate veil." *Id.* at 633. *But see* Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976) (criticizing Landers).

151. Bainbridge, *supra* note 1, at 528–34.

152. A distinction may arise at the judgment stage of the proceeding, however. Under enterprise liability, a judgment would be enforceable against the single business enterprise; under alter ego, the judgment could be separately enforced against either firm. In the latter case, moreover, a settlement by one presumably would not foreclose collection of the judgment against the other. *See* WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 43, at 727 (perm. ed. rev. vol. 1999).

prise liability all along. That being the case, courts ought to shed the misleading label and call the analysis by its true name.

B. *The Case Against Veil Piercing*

1. *The Costs of Veil Piercing*

As the veil piercing doctrine currently stands, there are two potential associated costs. The first is driven by the prospect of occasional judicial errors. In other words, courts presumably reach the wrong result in some cases because the doctrine is so flawed. Whether a case was wrongly decided, of course, often depends on who one asks. Yet, one can identify some cases in which most observers would likely conclude that the member did nothing for which he should be held personally liable and, accordingly, that the veil should not have been pierced. The *Haack*[153] and *Stone*[154] cases discussed above strike one as highly plausible candidates. If such cases are not infrequent, abolishing veil piercing would force courts to use doctrines such as the law of fraudulent conveyance that go more directly to the issues at hand.

Even if all veil piercing cases are coming out correctly in terms of result, there still is a second cost that arises out of the marginal effect of the doctrine on the incentives of small business owners. As we have seen, veil piercing focuses entrepreneurial incentives on the wrong issues, such as by encouraging them to spend time and effort on organizational formalities that simply do not address the real problem of negative externalities.[155]

Larry Ribstein has suggested that veil piercing's focus on organizational formalities is an information-forcing default rule.[156] But what information does veil piercing elicit, and to whom is the information provided? In other words, what information asymmetry does veil piercing solve?

As to voluntary creditors, recall that there is no externality[157] and, as a result, no information asymmetry that cannot be solved by negotiation. If voluntary creditors want their debtors to comply with specific organizational formalities, they can bargain for such compliance.[158] As to in-

153. New Horizons Supply Coop. v. Haack, No. 98-1865, 1999 Wisc. App. LEXIS 108 (Jan. 28, 1999); *see supra* note 27 for discussion of the case.

154. Stone v. Frederick Hobby Assoc. II, No. CV000181620S, 2001 WL 861822 (Conn. Super. Ct. Jul. 10, 2001); *see supra* notes 73–85 and accompanying text for discussion of the case.

155. *See supra* Part III.A.2.

156. *See* Larry E. Ribstein, *Welcome to Uncorporations* (Apr. 23, 2004), *at* http://busmovie.typepad.com/ideoblog/2004/04/welcome_to_unco.html.

157. *See supra* note 121 and accompanying text.

158. Some may claim that most creditors would bargain for such protections. As such, veil piercing emerges as a majoritarian default. Yet, there are at least two problems with this line of argument. First, where is the evidence that creditors demand compliance with the sort of organizational formalities with which veil piercing is concerned? Second, even if obtaining such compliance were the majori-

voluntary creditors, the problem is not information asymmetries vis-à-vis the equity claimants. By definition, there is no bargaining between the two. Instead, the only question is one of externalization of risk. As we have seen, veil piercing is poorly suited to deal with that problem.

2. *Tort Reform and Veil Piercing*

Entrepreneurs long could obtain the benefit of limited liability by incorporating. What the LLC brought to the table, however, was the ability to combine limited liability with the governance attributes of a partnership. In many small businesses, possibly excepting those that intend to go public in the short term, the combination of partnership-like governance and corporate-like limited liability is a very attractive option. The corporation's statutorily-prescribed governance structure is a hierarchical one which mandates the separation of ownership and control.[159] Such a structure is particularly well-suited to publicly held entities.[160] In contrast, governance in small businesses tends to be informal, with decisions being made by consensus.[161] Partnership law's default governance rules work well in such settings.[162] Because LLCs initially could not be publicly held, and even today publicly held ones remain quite rare, the combination of partnership governance and corporate limited liability has helped make LLCs the vehicle of choice for small businesses.[163]

tarian default, veil piercing's rare and seemingly arbitrary application makes it an odd choice as a vehicle for achieving such compliance.

159. *See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 466–68 (1992) (describing the structure of corporate governance as one grounded in a mode of decision making known as authority).

160. *See id.* at 466 (explaining that "In publicly held corporations, . . . management and residual claimants have sharply differentiated functions. This distinction is codified in all corporations statutes . . . .").

161. *See id.* at 467 (explaining that "an elaborate decision-making structure is unnecessary because the partners will tend to reach agreement informally and largely by consensus").

162. Dooley explains that:

> Not only is this aspect of partnership governance [i.e., consensus-based decision making] the one that is most frequently observed, it is also the one predicted by Kenneth Arrow's theories of organizational decision making. According to Arrow, where an organization's decision makers have identical information and interests, decisions will be reached by "Consensus" because each participant, voting in his or her own self-interest, will naturally select the course of action preferred by the others.

Id. (footnotes omitted).

163. *See, e.g.*, Stuart Levine, *LLCs—The Swiss Army Knife of Business Organizations*, PARTNERSHIPS, LLCS, AND LLPS: UNIFORM ACTS, TAXATION, DRAFTING, SECURITIES, AND BANKRUPTCY, SJ003 A.L.I.-A.B.A. 1097, 1101 (2003) (opining that "LLCs are now the vehicle of choice for most closely-held business start-up companies"); Richard Wild & Michael Hirschfeld, *Check-the-Box Knows no Boundaries (At Least, for the Moment)—2002 Update*, TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2002, 551 P.L.I./TAX 1029, 1039 (2002) (opining that "The LLC has generally become the vehicle of choice when non-corporate tax status and limited liability are desired.").

In an increasingly litigious society, however, expansive tort liability threatens the viability of small business. The Council of Economic Advisers reports that:

> With estimated annual direct costs of nearly $180 billion, or 1.8 percent of GDP, the U.S. tort liability system is the most expensive in the world, more than double the average cost of other industrialized nations that have been studied. This cost has grown steadily over time, up from only 1.3 percent of GDP in 1970, and only 0.6 percent in 1950.[164]

As George Priest has noted, it is "plausible that the expansion of enterprise liability since the 1970s in tort law has imposed differentially burdensome costs on small business," albeit one tempered by other government subsidies.[165]

Truly limited liability free of the risk of veil piercing could be viewed as one of the alternative government subsidies that offsets the differential burden of the tort system on small business. Interestingly, Larry Ribstein suggests that the spread of unincorporated limited liability entities, such as the LLC, was a backdoor mechanism for achieving tort reform.[166] One thus may infer that the legislative expansion of the availability of limited liability reflects a shift in legislative intent "from merely encouraging and protecting passive investors to actively promoting business."[167]

The benefit of such a subsidy goes beyond the standard rationale of promoting capital formation. Stephen Presser has shown that limited liability was an outgrowth of populist democratic theory.[168] The nineteenth-century legislators who first adopted limited liability as a central feature of corporate law did so, Presser contends, to encourage small and impecunious entrepreneurs to start and develop new businesses.[169] Entrepreneurs and other small business owners who tie up the bulk of their financial and human capital in their business have limited ability to protect that investment through diversification.[170] Without the shield of limited liability, accordingly, only very wealthy persons would incorporate new businesses.[171] Only persons of preexisting wealth could afford to

164. COUNCIL OF ECONOMIC ADVISERS, WHO PAYS FOR TORT LIABILITY CLAIMS? AN ECONOMIC ANALYSIS OF THE U.S. TORT LIABILITY SYSTEM 1–2 (2002), *available at* http://www.whitehouse.gov/cea/tortliabilitysystem_apr02.pdf.

165. George L. Priest, *Small Business, Economic Growth, and the Huffman Conjecture*, 7 J. SMALL & EMERGING BUS. L. 1, 9 (2003).

166. *See* Larry E. Ribstein, *The Evolving Partnership,* 26 J. CORP. L. 819, 836 (2001). A relationship between the LLC's evolution and tort reform is suggested by the strong opposition LLC statutes faced in several states from the trial lawyers lobby. *Id.* (noting trial lawyers' lobbying efforts in several states).

167. Matheson & Eby, *supra* note 138, at 171.

168. Presser, *supra* note 3, at 155–56. *See generally* Cohen, *supra* note 26, at 442–44 (discussing Presser's argument from democratic principles); Huss, *supra* note 19, at 103–04 (same).

169. Presser, *supra* note 3, at 155–56.

170. *See* Huss, *supra* note 19, at 107 (noting this argument).

171. Presser, *supra* note 3, at 156.

start a new business while maintaining a diversified portfolio of investments. This situation, Presser argues, was precisely what limited liability was intended to remedy:

> The popular democratic justification for limited liability is rarely observed by modern scholars. Nevertheless, it appears that to the nineteenth-century legislators in states such as New York, who mandated limited liability for corporations' shareholders, the imposition of limited liability was perceived as a means of encouraging the small-scale entrepreneur, and of keeping entry into business markets competitive and democratic. . . .
>
> . . . New York's policy of limited liability, and its policy of encouraging incorporation by persons of modest means "facilitated the growth of a viable urban democracy by allowing a wide participation in businesses that could most advantageously be organized as corporations." "More importantly," . . . New York's general incorporation statutes "helped equalize the opportunities to get rich. The passage of general incorporation laws for business corporations was the economic aspect of the political and social forces that democratized the United States during the Age of Jackson, 1825–1855."[172]

Indeed, as Michael Novak has observed, the pursuit of wealth by entrepreneurs has been a major factor in destroying arbitrary class distinctions by enhancing personal and social mobility.[173]

Presser goes on to observe that:

> If we consider the evidence from history . . . , we see that limited liability came about because of a wish to further economic progress and to maximize state wealth through encouraging investment. Moreover, . . . it appears that an equally important factor contributing to limited liability's present stronghold in American corporate law was a desire to encourage individual investment in smaller firms. It is of a piece with other nineteenth-century manifestations of rugged individualism, and reflects a traditional American policy to favor the small-scale entrepreneur. Limited liability, insofar as it reflects a venerable desire to help out smaller investors, those more typical of the people, thus reflects democracy as much as economics. Perhaps, then, limited liability ought to be most sacred for smaller firms, and not those possessing great economic wealth.[174]

With the LLC having displaced the close corporation as the vehicle of choice for smaller firms, Presser's argument from democratic theory now applies to LLCs even more forcefully than it does to corporations.[175]

172. *Id.* at 155–56 (footnotes and emphasis omitted).

173. MICHAEL NOVAK, TOWARD A THEOLOGY OF THE CORPORATION 42 (rev. ed. 1990).

174. Presser, *supra* note 3, at 163 (footnotes omitted).

175. An additional reason for treating LLCs differently than corporations is suggested by the nexus of contracts theory of the firm. Recall that the contractarian model views statutes governing business organizations as a set of off the rack default rules. One advantage to having multiple forms of business organizations is that parties can select the set of rules that most closely tracks their needs and,

IV. CONCLUSION

Pro-piercing commentators typically argue that it would be "unfair to allow LLCs to possess the positive aspects of limited liability . . . without also carrying the negative possibility of piercing."[176] This argument assumes a fact not in evidence—namely, that veil piercing is sound public policy. In this article, I have demonstrated that the emerging doctrines for piercing the LLC veil are hopelessly dysfunctional. They encourage inefficient investment in irrelevant precautions, while encouraging expensive and complex litigation. They may discourage capital formation in small businesses by exposing those businesses to a disproportionate share of the burden from the tort liability system, which in turn undermines the valuable democratic contribution—at the risk of being too corny, the American dream—of small business ownership and entrepreneurship.

accordingly, reduces their bargaining costs. Put another way, because investors are heterogeneous the best approach may be to offer them a significant choice. Courts may maximize investor welfare by letting investors choose the form best suited to their business, and different legal rules for LLCs and corporations would do just that.

176. Schwindt, *supra* note 33, at 1552.