Limited Liability Companies: A Critique

Rachel Maizes
LIMITED LIABILITY COMPANIES: A CRITIQUE

The widespread adoption of limited liability company ("LLC") statutes has been a much-heralded development in corporate law. At least forty-seven states have passed such statutes and the remaining states are considering proposals for the passage of LLC legislation. Because the LLC can provide investors with limited liability, pass-through taxation, and far more organizational flexibility than a limited partnership or a corporation organized under Subchapter S of the Internal Revenue Code ("S-corporation"), some commentators have suggested that it is destined to become the business organizational form of the

---

1 See, e.g., Robert R. Keatinge et al., The Limited Liability Company: A Study of the Emerging Entity, 47 BUS. LAW. 375, 380 (1992) ("LLC, which combines the tax advantages of a partnership with limited liability for all members, offers significant advantages over other pass-through entities such as the general partnership, limited partnership, or S corporation."); Larry E. Ribstein, The Deregulation of Limited Liability and the Death of Partnership, 70 WASH. U. L.Q. 417, 475 (1992) ("[D]evelopment and tax recognition of LLCs promises to change the law of business associations radically."); Scott Kapusta & Brian Nichols, Note, Limited Liability Companies: The Optimal Business Organization for the Twenty-First Century? 9 ST. JOHN'S J. LEGAL COMMENT. 803, 803 (1994) (stating that "limited liability company ... is one of the most significant recent developments relating to business organizations").

2 Susan Pace Hamill, Statement of Susan Pace Hamill on the Need for and the Benefits of the S Corporation Reform Act of 1995, FED. DOCUMENT CLEARING HOUSE, June 19, 1995, available in LEXIS, Legis Library, Congst File. The only states without LLC statutes are Hawaii, Massachusetts, and Vermont. Id.

3 Id.

4 See infra note 32 and accompanying text (describing limited liability in an LLC).

5 See infra note 33 and accompanying text (describing taxation of LLCs). The model for flow-through taxation is the partnership. A partnership is not taxed as an entity. Rather, income of the partnership is attributed to the partners, who are taxed as individuals on that income. See I.R.C. § 701 (West 1988).

6 See infra notes 35-42 and accompanying text (explaining that S-corporations allow for both limited liability and pass-through taxation but are subject to more restrictions than LLCs).
future. According to one estimate, 50,000 LLCs have already been formed.

A brief comparison of the new form with more traditional business forms demonstrates why the LLC is such an attractive investment vehicle. In the past, investors who wanted to participate in management and qualify for pass-through taxation were largely restricted to the partnership form, an option subjecting partners to personal liability for the obligations of the partnership. Now, however, investors have the additional choice of the LLC, which has the benefit of providing members with a means of limiting their liability to the amount of their investment. Similarly, investors who might have chosen to invest in limited partnerships to qualify for both pass-through taxation and limited liability, can now organize as an LLC. Whereas limited partners could lose their limited liability if they participated in the control of the entity, members of an LLC are permitted to exercise management control.

While the new form may be a boon to investors, its impact on society as a whole is less clear. LLC legislation effectively reduces federal corporate tax rates by allowing more business entities to achieve the benefits of corporate status (such as limited liability) without paying entity level taxation. This reduction

---

7 See, e.g., Wayne M. Gazur & Neil M. Goff, Assessing the Limited Liability Company, 41 CASE W. RES. L. REV. 387, 391 (1991) ("[T]he federal income tax advantages of the LLC, coupled with limited liability for all participants, may render the LLC the most desirable tax conduit entity."); Keatinge et al., supra note 1, at 408 ("In sum, LLCs ultimately may replace other forms of closely held limited liability business entities including limited partnerships and close corporations. Indeed, it is even conceivable that LLCs will replace general partnerships for most purposes."); Ribstein, supra note 1, at 427 ("Most firms that now organize as general partnerships probably will not continue to do so once restrictions on limited liability have been loosened through recognition of the LLC form."); Jeff Barge, Firms Look To Convert to Entity Limiting Risk, CRAIN'S N.Y. BUS., Oct. 24, 1994, at 16 ("[W]hen it comes to the formation of new companies, the LLC seems poised to replace older and less flexible forms such as limited partnerships and Subchapter S corporations.").


10 See infra note 32 and accompanying text.


12 See infra note 58 and accompanying text.

13 See Daniel S. Goldberg, Tax Treatment of Limited Liability Companies: Law in Search of Policy, 50 BUS. LAW. 995 (1995) ("[T]ax treatment of LLCs has broad implications for the federal revenue. To the extent a business can be conducted
was achieved without the benefit of a national debate that would have accompanied federal legislation to accomplish the same purpose.14

Furthermore, as partnerships convert to limited liability companies, and as new businesses organize in the LLC form, the number of investors protected by the shield of limited liability...
will grow. Is a widespread expansion of limited liability desirable? Corporate limited liability allows enterprises to externalize some of their costs.\textsuperscript{15} It also creates an incentive for corporations to engage in risky behavior, knowing that although the full benefit of any success will accrue to shareholders, the cost of failure or injury can be spread among shareholders (whose loss is limited to their initial investment), creditors (whose loss is limited to the amount of credit extended),\textsuperscript{16} and those injured by the acts of the corporation (whose loss is potentially unlimited).\textsuperscript{17} Thus, limited liability is at odds with modern tort law which requires that enterprises “pay their own way.”\textsuperscript{18} Yet certain policy justifications have been advanced for allowing corporate shareholders to limit their liability.\textsuperscript{19} Do these policies support limited liability for members of limited liability companies?

In their hurry to pass LLC legislation,\textsuperscript{20} and faced with pres-

\textsuperscript{15} See Phillip I. Blumberg, Limited Liability and Corporate Groups, 11 J. CORP. L. 573, 576 (1986); Henry Hansmann & Reinier Kraakman, Toward Unlimited Shareholder Liability for Corporate Torts, 100 YALE L.J. 1879, 1879 (1991) (providing example of corporate externalization of costs in context of limited liability in tort); Robert B. Thompson, Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise, 47 VAND. L. REV. 1, 1 (1994). But see Ribstein, supra note 1, at 439 (arguing that “potential for externalities may be less than has been supposed”).

\textsuperscript{16} See Frank H. Easterbrook & Daniel R. Fischel, Limited Liability and the Corporation, 52 U. CHI. L. REV. 89, 90 (1985) (observing that lenders also have limited liability). It seems that only “involuntary creditors” such as tort victims have true unlimited liability.

\textsuperscript{17} Id. at 104 (noting that “shareholders of a firm reap all of the benefits of risky activities but do not bear all of the costs”).

\textsuperscript{18} See id.; Thompson, supra note 15, at 2 (stating that limited liability “seems inconsistent with the increased use of strict liability and other modern tort doctrines to extend liability to the enterprise”); see also Paul Halpern et al., An Economic Analysis of Limited Liability in Corporation Law, 30 U. TORONTO L.J. 117, 145 (1980) (stating “limited liability ... may undermine the deterrent objectives of the tort system”); Note, Should Shareholders Be Personally Liable for the Torts of Their Corporations?, 76 YALE L.J. 1190, 1195 (1967) (“[L]imited liability thwarts the objectives of modern tort law—compensation for the injured, deterrence of future accidents, and punishment of the personally culpable.”).

\textsuperscript{19} See infra Part III.

\textsuperscript{20} Prior to 1990 only two states, Wyoming and Florida, had passed LLC statutes. Keatinge et al., supra note 1, at 378 n.3.

The frenzy with which states have acted is perhaps best illustrated by the passage of the legislation in California as an “urgency measure,” which went into effect immediately upon enactment, although state officials argued they would be unable to administer the law that quickly. See CAL. SENATE COMM. ANALYSIS, Aug. 15, 1994.
sure both from the legal and business communities,\textsuperscript{21} few state legislatures seem to have considered these questions.\textsuperscript{22} While states have examined possible revenue losses from the measures,\textsuperscript{23} few have studied the consequences of shifting business losses onto creditors and tort victims. The academic literature on the subject of LLCs has been similarly accepting of the new form.\textsuperscript{24} This is surprising in light of the extensive debate surrounding corporate limited liability.\textsuperscript{25} It is also surprising in

\textsuperscript{21} See infra notes 69-85 and accompanying text.
\textsuperscript{22} See, e.g., Timothy Middleton, Corporate Form Offers Unlimited Appeal, CRAIN'S N.Y. BUS., Apr. 20-26, 1992, at 9 (noting absence of organized opposition to New York LLC legislation).
\textsuperscript{23} See, e.g., GOVERNOR'S PROGRAM BILL, supra note 13, at 12 (predicting loss to New York State of "$40 million annually by the fifth year following the adoption of the LLC" but suggesting "loss will be offset somewhat by increased business activity in New York State"); Alan Breznick, Accountants Seek Entity To Limit Liability, CRAIN'S N.Y. BUS., Aug. 31-Sept. 6, 1992, at 3 (noting that major hurdle to passage of LLC bill in New York is legislature's concern with loss of revenue); Daniel B. Moskowitz, New Way To Organize Business Is Gaining Wider Acceptance, WASH. POST, Nov. 4, 1991, at F14 ("The big fear in many legislatures is that LLCs will cost states revenue."); Limited Liability Partnerships for Law Firms, MASS. LAW. WKLY., Aug. 14, 1995, at 10 ("Although the creation of limited liability companies could result in some direct loss of tax revenue for the commonwealth, proponents of the LLC bill argue that any tax losses will be offset by attracting new businesses and keeping existing businesses in-state.").
\textsuperscript{24} See, e.g., Peter D. Hutcheon, The New Jersey Limited Liability Company Statute: Background and Concepts, 18 SETON HALL LEGIS. J. 111, 160 (1993) ("LLCs are, much like the common law constructs of the judges of King's Bench and perhaps especially Lord Mansfield, a reasoned and practical response to the needs of business and commercial transactions.").
\textsuperscript{25} Halpern et al., supra note 18, at 117 ("[T]he] merits of the doctrine of limited liability in corporation law have been the subject of passionate disagreement amongst otherwise level-headed commentators... ").

For examples of scholars who favor retaining corporate limited liability, see Easterbrook & Fischel, supra note 16, at 92 (arguing that limited liability is necessary for efficient functioning of capital markets); Richard A. Posner, The Rights of Creditors of Affiliated Corporations, 43 U. CHI. L. REV. 499 (1976) (supporting limited liability within corporate groups); Stephen B. Presser, Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics, 87 NW. U. L. REV. 148 (1992) (developing idea that limited liability was necessary to "democratize" opportunities for investment).

Scholars who would reduce the liability shield of corporations include Blumberg, supra note 15, at 576-77 (criticizing application of limited liability to corporate groups); Theresa A. Gabaldon, The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders, 45 VAND. L. REV. 1387, 1454 (1992) (criticizing corporate limited liability from feminist perspective and suggesting scheme of mandatory insurance to mitigate some of its social harms); Hansmann & Kraakman, supra note 15, at 1896 (advocating unlimited pro rata shareholder liability for corporate torts); David W. Leebron, Limited Liability, Tort Victims, and Creditors, 91 COLUM. L. REV. 1565, 1569 (1991) (also suggesting pro rata share-
light of the increased willingness of some courts to disregard corporate limited liability and pierce the corporate veil.\textsuperscript{26}

LLCs, which can be managed by investors who have limited liability, resemble close corporations.\textsuperscript{27} Yet it is in the context of close corporations that limited liability has received the most scrutiny,\textsuperscript{28} and that courts have been most willing to hold investor liability for corporate torts); Lawrence E. Mitchell,\textit{ Close Corporations Reconsidered}, 63 Tul. L. Rev. 1143, 1147-48 (1989) (criticizing limited liability as well as other corporate attributes in close corporation setting); Note,\textit{ supra} note 18, at 1196 (suggesting choice of unlimited shareholder liability or compulsory liability insurance for active investors in close corporations); see also Peter Z. Grossman,\textit{ The Market for Shares of Companies with Unlimited Liability: The Case of American Express}, 24 J. Legal Stud. 63, 66 (1995) (tracing history of modern unlimited liability firm and disputing notion that limited liability is necessary for functioning of capital markets); see generally, Halpern et al.,\textit{ supra} note 18 (suggesting unlimited liability regime for closely held companies).

For the view that limited liability is economically irrelevant, see Roger E. Meiners et al.,\textit{ Piercing the Veil of Limited Liability}, 4 Del. J. Corp. L. 351 (1979).


For a comprehensive discussion and criticism of the federal policy in this area see \textit{Stephens B. Presser, Piercing the Corporate Veil} § 3 (1991).

For the contrary view that courts are no more likely to pierce the corporate veil today than they have been at any time during the past few decades, see Robert B. Thompson,\textit{ Piercing the Corporate Veil: An Empirical Study}, 76 Cornell L. Rev. 1036, 1048-49 (1991).

\textsuperscript{27} Eric Fox, Note,\textit{ Piercing the Veil of Limited Liability Companies}, 62 Geo. Wash. L. Rev. 1143, 1152 (1994) (“The nature of the LLC interest, therefore, resembles a partnership, or a closely held corporation, where participation in management is the rule rather than the exception.”); cf. Keatinge et al.,\textit{ supra} note 1, at 395 (noting that because LLC statutes restrict transferability of interests “almost all LLCs will be closely held”); Ribstein,\textit{ supra} note 1, at 428 (“increased availability of limited liability through LLCs is likely to affect mostly closely held firms”).

\textsuperscript{28} See Mitchell,\textit{ supra} note 25, at 1147-48 (criticizing limited liability as well as other corporate attributes in close corporation setting); see also Easterbrook & Fischel,\textit{ supra} note 16, at 110 (benefits of limited liability in close corporation setting are fewer, while “incentive ... for managers to undertake overly risky projects is
tors personally liable. The discomfort with limited liability in the close corporation setting should signal caution with regard to extending limited liability to another class of owner-managers, such as LLC members.

This Note questions the wisdom of increasing the number of investors protected by a limited liability shield, particularly when the investors are involved in the management of the enterprise. Part I briefly describes the major features of LLCs. Part II traces the history of the new business entity and exposes the forces behind its sudden popularity. It explains why little opposition to the form has surfaced, despite its potential for social harm. Part III explores the traditional justifications for limited liability in the corporate context to see whether they support extending limited liability to LLC members. Part IV looks at the criticisms that have been leveled against limited liability in the corporate context to determine whether they would apply equally, or more forcefully, against limited liability in the LLC context. Included in this part is a discussion of the policies supporting enterprise liability and their applicability to LLCs. Finally, Part V suggests a scheme of mandatory insurance to mitigate the potentially harmful effects of LLCs.

I. MAJOR FEATURES OF LIMITED LIABILITY COMPANIES

The LLC is a new organizational form which, if properly structured, combines the limited liability of a corporation with much more severe); Halpern et al., supra note 18, at 149 ("unlimited liability regime is the most efficient regime for small, closely held companies"); Note, supra note 18, at 1196-97 (advocating unlimited tort liability for shareholders of close corporations).

31 See Mitchell, supra note 25, at 1169 ("[C]lose corporations are at a significantly greater risk of veil-piercing than publicly held corporations."); see also Easterbrook & Fischel, supra note 16, at 109 ("[A]lmost every case in which a court has allowed creditors to reach the assets of shareholders has involved a close corporation."); Thompson, supra note 26, at 1038 ("likelihood of piercing increases as the number of shareholders decreases").

32 Lawrence Mitchell conducts a similar analysis for close corporations in which he concludes that limited liability is not justified in firms where owners manage. See supra note 25.

Wyoming enacted the first limited liability company statute in 1977. Gazur & Goff, supra note 7, at 389. However, the form did not really begin to catch on until 1988, when the I.R.S. issued Revenue Ruling 88-76, which determined that a Wyoming limited liability company would be taxed as a partnership. Id. at 390; Rev. Rul. 88-76, 1988-2 C.B. 360.

33 The language granting limited liability to LLC members is even broader than the language granting limited liability to corporate shareholders. Compare, e.g.,
the pass-through taxation of a partnership.\(^3\) Adding to its ap-

---


Since all LLCs contain the corporate characteristic of limited liability, they must currently be structured to lack two of the remaining three corporate characteristics to avoid entity-level corporate taxation. Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 565, 567-68 (1995); Keatinge et al., *supra* note 1, at 385. That requirement, however, may soon change. The I.R.S. is currently considering allowing unincorporated businesses simply to elect whether they wish to be taxed as corporations or partnerships. I.R.S. Notice 95-14, 1995-14, I.R.B. 7. The current rule prohibiting publicly traded partnerships (or LLCs) from achieving pass-through taxation, however, will not change. See I.R.C. § 7704 (West 1995).

In drafting their LLC statutes, some states incorporated provisions that guarantee that an LLC formed in the state will meet current requirements for partnership taxation (i.e., they will lack two corporate characteristics). BISHOP & KLEINBERGER, *supra* note 13, ¶ 2.09[3], at 2-151 to 2-132 (citing, as example of “bulletproof” statute, Wyoming LLC statute which requires dissolution upon certain events and re-
peal, the new entity is far more flexible than older limited liability organizational forms.34

Unlike a limited partnership, the LLC is not required to have a general partner (i.e., someone with full personal liability).35 Unlike limited partners, investors in an LLC (called "members") can manage the business without jeopardizing their limited liability status.36 Similarly, the LLC is not subject to the many constraints under which the S-corporation operates. S-corporations are limited to a single class of stock37 and a maximum of thirty-five shareholders, all of whom must be individuals and United States citizens.38 By contrast, the ownership and profit-sharing arrangements that can be adopted by LLCs are highly flexible.39 Finally, the LLC also provides advantages for investors over the corporate form.40 Corporate formalities, such

---

34 Keatinge et al., supra note 1, at 417 ("Because the LLC statutes provide only a minimal number of mandatory rules, LLC members have a great deal of freedom in organizing the LLC's economic and management structure."); see also Barge, supra note 7, at 16 (noting that New York's LLC statute eliminates need for corporate formalities such as directors, officers, bylaws and minutes); Fox, supra note 27, at 1147 (citing "flexible management alternatives" as one of the "most important provisions" LLCs have to offer).

35 The Revised Uniform Limited Partnership Act defines a limited partnership as having "one or more general partners and one or more limited partners." R.U.L.P.A. §101(7).

36 See supra note 11 and accompanying text.


39 But see infra note 64 and accompanying text (noting debate over whether LLCs can be comprised of only one member and receive beneficial tax treatment).

40 LLCs will not qualify for pass-through taxation if they are publicly traded. See I.R.C. § 7704 (West 1995). One can imagine a situation where investors would choose to organize a publicly-traded entity as an LLC rather than a corporation. Al-
as management by a board of directors, need not be observed, and profits and losses can be shared without regard to the amount or form of capital invested.

Because the LLC has tax and structural advantages over other limited liability forms, it has caused a great deal of excitement among lawyers. Accordingly, investors across the nation have rushed to organize as LLCs. To form an LLC, an organizer, who need not be a member of the LLC, files articles of organization. The resulting enterprise is governed by an operating agreement adopted by the members.

LLCs can be formed for a broad range of purposes. Profes-
sional firms have been among the first to reorganize as LLCs. The LLC has been touted for joint ventures and venture capital firms, among other uses. Likewise, they have been recommended for closely held companies and for risky ventures such as start-ups, oil and gas ventures, and real estate transactions.

U.L.C.A. § 112(a) (1994) (amended 1995) ("limited liability company may be organized under this [Act] for any lawful purpose, subject to any law of this State governing or regulating business"); see also Keating et al., supra note 1, at 419 ("states have imposed few restrictions upon an LLC's activities").

James Woehlke et al., LLCs: The Business Planner's Dream Entity, CPA J., June, 1995, at 16. However, not all states allow professionals to organize as LLCs. Bryan Smith, Comment, The Professional Liability Crisis and the Need for Professional Limited Liability Companies: Washington's Model Approach, 18 SEATTLE UNIV. L. REV. 557, 560 (1995) ("three states prohibit professionals from becoming LLCs ... thirty-six allow them to do so, and the remainder of the states omit any mention of use by professionals."). (citations omitted); see also BISHOP & KLEINBERGER, supra note 13, ¶ 6.06(1), at 6-49 to 6-52.

For professionals to practice in LLC form, in addition to enabling legislation, they need the approval of the agency regulating the practice of that profession. Keatinge et al., supra note 1, at 458. Thus, whether attorneys can organize under a state LLC statute, is a matter for the state bar association or the state highest court. Id.; see also Thom Weidlich, Limiting Lawyers' Liability: LLPs Can Protect Assets of Innocent Partners, NAT'L L.J., Feb. 7, 1994, at 1 ("supreme courts in about half [the] states [with LLC statutes] have not changed their ethics rules to allow lawyers to form them"). The American Institute of Certified Public Accountants (A.I.C.P.A.), which regulates which business forms accountants may adopt, voted in 1990 "with overwhelming approval" to allow accountants to organize in LLC form. Keatinge et al., supra, note 1, at 459. They did so without requiring any minimum capitalization or minimum insurance. Id.


BISHOP & KLEINBERGER, supra note 13, ¶ 1.02(1), at 1-13; Kontzer, supra note 13, at 3 ("likely candidates to form LLCs include venture capital firms").

Jim Connolly, Limited Liability Cos.' Use Rises in Real Estate Deals, NAT'L UNDERWRITER, May 2, 1994, at 67 (suggesting LLCs for institutional investors who "demand more of a say in their investments"); Gerry Donohue, New Business Entity Attracts Builders, BUILDER, May, 1994, at 156 (suggesting LLCs for developers).

Brian L. Schorr & Sylvia Wong, New York Enacts Limited Liability Company Law, INSIGHTS, Oct. 1994, at 24 (suggesting use of LLCs for family businesses and "entrepreneurial businesses with a small number of active investors").

Woehlke et al., supra note 48, at 16 ("To date, the key uses of LLCs have been businesses traditionally conducted in the partnership form, but which entail a high level of risk.").

Barge, supra note 7, at 16 ("LLCs are attractive to high-risk ventures such as start-ups or high-tech firms"); Middleton, supra note 22, at 9 (noting LLCs use for "start-ups, small businesses and enterprises looking for outside investors").

The truth is that the form is so new and so flexible no one is certain what investors will do with it.\(^5\) One thing is clear, however, one of the keys to the success of the new form is its potential for liability avoidance. As discussed in Part IV, the wide availability of limited liability in an entity where investors manage may have damaging social consequences.

LLC statutes permit members either to manage the LLC or to choose member or non-member managers.\(^6\) In a member-managed LLC, each member is an agent of the LLC, and the LLC is bound by the acts of any member having actual or apparent authority.\(^5\) In contrast, members of a manager-managed LLC are not agents of the LLC.\(^6\) While interests in an LLC are assignable,\(^6\) as in a partnership, assignment of an interest does not automatically provide the assignee with management rights.\(^6\) Some statutes even permit the formation of an LLC

---

\(^5\) Gregory P. Pressman & Stephanie R. Breslow, *New Limited Liability Company Law Goes Into Effect*, N.Y. L.J., Sept. 26, 1994, at S1 (comparing LLC to older business forms for real estate ventures, and suggesting LLC is superior to partnerships in avoiding liability for “environmental noncompliance, taxes, torts, [and] claims” and superior to corporations in allowing members to write off depreciation, amortization, and other losses on personal income taxes); *IRS Makes Limited Liability Companies More Attractive*, ROANOKE TIMES & WORLD NEWS, Apr. 23, 1995, at F1 (noting that LLC “protects commercial real estate investors in an era when lawsuits over fair housing complaints, Americans with Disabilities Act complaints and third-person assaults on tenants threaten the economic welfare of property owners”); see also Gazur & Goff, supra note 7, at 470 (estate planning); Keatinge et al., supra note 1, at 407-9 (professional firms); Kontzer, supra note 13, at 3 (venture capital firms, real estate developers and small industrial companies); Middleton, supra note 22, at 9 (real estate joint ventures).

\(^6\) Woehlke et al., supra note 48, at 16 (“Business advisors have only begun exploring the uses that the unique set of features offered by the LLC brings to the table.”).


\(^3\) See, e.g., DEL. CODE ANN. tit. 6, § 18-702(a) (1992) (amended 1994).

\(^4\) Statutes incorporate restrictions on transferability to assist LLCs in qualifying for pass-through taxation. See supra note 33 and accompanying text. Some statutes simply provide a default rule. See, e.g., DEL. CODE ANN. tit. 6, § 18-704 (1992):

(a) An assignee of a limited liability company interest may become a mem-
with only one member. However, the Internal Revenue Service ("I.R.S.") has not yet ruled on whether a single-member LLC would be classified as a partnership for income tax purposes.

II. FORCES BEHIND LLC ADOPTIONS

Why have states rushed to pass LLC legislation? Critical to the acceptance of this new organizational form was a 1988 Revenue Ruling, classifying a Wyoming LLC as a partnership for tax purposes. Absent pass-through taxation, LLCs present few benefits over the corporate form. Initially, however, the I.R.S. proposed regulations that required any firm in which all members possessed limited liability to be taxed as a corporation. These regulations would have required LLCs to pay entity-level taxation. The I.R.S. withdrew the proposed regulations, however, when faced with strong opposition from the business community. One author has suggested that tax regulations will continue to favor LLCs because no "powerful interest group" is injured by them.

Another impetus behind the adoption of LLC statutes is

ber as provided in a limited liability company agreement and upon:
(1) The approval of all of the members of the limited liability company other than the member assigning his limited liability company interest;
or
(2) Compliance with any procedure provided for in the limited liability company agreement.

Id.; N.Y. LIMIT. LIAB. CO. LAW § 603 (1994) ("Except as provided in the operating agreement ... an assignment of a membership interest does not ... entitle the assignee to participate in the management and affairs of the limited liability company. ... ").


See Alan E. Weiner & James A. Woehlke, Temporary Regs Needed for Single-Member LLCs, ACCT. TODAY, Dec. 12, 1994, at 53 (noting uncertainty in I.R.S. treatment of single-member LLCs and calling on I.R.S. to issue temporary regulations to guide investors); see also, BISHOP & KLEINBERGER, supra note 13, ¶ 3.02[2], at 3-5 n.12 (suggesting that single-member LLCs will be classified as corporations for income tax purposes); Keatinge et al., supra note 1, at 430 ("LLCs must have at least two members to secure partnership status").

Rev. Rul. 88-76, 1988-2 C.B. 360; see supra note 33 (discussing Revenue Ruling in detail); see also supra note 20 (explaining that prior to ruling only two states, Wyoming and Florida, had passed LLC legislation).


See Ribstein, supra note 1, at 473.
competition among states for business and filing fees. In a classic "race for the bottom" scenario, the first LLC statutes were adopted with the goal of attracting business, while subsequent state adoptions have been triggered by a fear of being left out. Promoters of the legislation also claim LLCs will increase overall

69 GOVERNOR'S PROGRAM BILL, supra note 13, at 12 ("The bill will attract businesses to New York State.... Adoption of LLC legislation in New York will be a significant step in promoting New York as a competitive location for conducting and establishing business enterprises"); Gazur & Goff, supra note 7, at 389 (noting that Wyoming legislators hoped to "lure business to their state" or at least "organizational activities"); Ribstein, supra note 1, at 473.

The arguments that have been advanced to support the passage of LLC statutes are many of the same arguments that were raised in support of limited liability for corporations in the 19th Century. For example, in 1825, in a speech to the Massachusetts legislature, Governor Levi Lincoln said a policy of unlimited liability was driving capital from the state. E. Merrick Dodd, The Evolution of Limited Liability in American Industry: Massachusetts, 61 HARV. L. REV. 1351, 1366-67 (1948). The author disputes Governor Lincoln's assertion. Id. at 1368; see also Mitchell, supra note 25, at 1168 (explaining that no definite legislative policy led to adoption of limited liability as general principle).

70 The first LLC statute was created as special interest legislation for an oil company. Keatinge et al., supra note 1, at 383. Florida passed an LLC statute to attract foreign businesses accustomed to the Limitada form, a limited liability entity somewhat similar to the LLC that exists in Latin America. Gazur & Goff, supra note 7, at 388-89 and n.8. See also Daily Rep. for Exec., BNA, July 19, 1991, at H-6 ("Texas has adopted a limited liability company law ... designed to encourage business formation in the state.").

71 See, e.g., New York State Division of the Budget Recommendation of Senate Bill 7511-A (recommending LLC legislation because it would "attract more businesses to either come to New York or deter out-migration to competing states"); CAL. SENATE COMM. ANALYSIS, Aug. 31, 1994 ("California should quickly adopt this bill so that it will be competitive with 35 other states which have adopted LLCs"). California adopted the legislation as an "urgency" measure that went into effect the day it was passed, despite concern that the Secretary of State would be unable to immediately administer a law of that magnitude. CAL. SENATE COMM. ANALYSIS, Aug. 15, 1994; see also Kntzer, supra note 13, at 3 (describing legislation as "urgency" measure, despite strong opposition from California Trial Lawyers Association).

Similarly, New York adopted the LLC form amid concern of losing new business. See Breznick, supra note 23, at 3 (warning that delay in passage "could cost New York dearly in the fierce competition among states for new business"); Karon Walker, New York Considers a Hybrid: Limited Liability Companies, N.Y. L.J., Oct. 12, 1993, at 12 (warning that New York, which had not yet passed LLC legislation, faced danger that neighboring states that had enacted LLC legislation would "lure businesses eager to use [the form] away from New York"); see also Limited Liability Partnerships for Law Firms, MASS. L.AW. WRKLY, Aug. 14, 1993, at 10 (noting that Massachusetts, which had not yet passed LLC or LLP statute "needs some form of limited liability entity to remain competitive with other states in attracting and keeping businesses ... Many lawyers in the commonwealth are concerned that legal business is being lost to out-of-state lawyers").
Perhaps no group has lobbied more vigorously for passage of LLC legislation than professionals. Lawyers and accountants hope to organize as LLCs, or as limited liability partnerships, a related business form, in an attempt to limit their malpractice exposure. Professionals who organize as a general partnership are jointly and severally liable for malpractice committed by a member of the firm. By contrast, while the assets of the LLC are available to satisfy a judgment against a member of the firm, a professional is not personally liable for the malpractice of another member solely by reason of being a member of an LLC.

The limitation of personal liability for professionals has become more important than ever because they are increasingly the targets of lawsuits. For example, government regulators...
have sued accountants and lawyers for their roles in the savings and loan crisis and the Bank of Credit and Commerce ("B.C.C.I.") scandal,\textsuperscript{80} extracting multi-million dollar settlements.\textsuperscript{81} The size of professional malpractice awards generally has also been rising.\textsuperscript{82} Accounting firms have collapsed under the weight of these judgments, leaving partners to pay for the shortfall out of their own personal assets.\textsuperscript{83} Thus, for professional firms, which are generally not asset-rich, regulator suits raise the specter of personal bankruptcy for partners.\textsuperscript{84} Another separate, but important benefit for lawyers and accountants in the passage of LLC legislation, is the increase in the demand for their services, as businesses reorganize under the new form.\textsuperscript{85} Ironically, professionals are the one group that has met with strong opposition in their attempt to organize as LLCs.\textsuperscript{86} The
plaintiffs’ bar and the public have prevented professionals from organizing under this form in some states. Yet even plaintiffs’ lawyers, perhaps the most natural opposition to any liability limiting measure, face a conflict of interest in opposing LLCs. On the one hand, they want to reach the assets of individual investors when representing clients; on the other hand, they hope to limit their own exposure for malpractice by organizing as LLCs.

Nevertheless, perhaps the main reason for the success of the new form is the lack of an organized opposition. This is not surprising, however, considering that the people most likely to be hurt by the legislation, future tort victims who will be unable to reach individual investor’s assets, are not yet identifiable. The legislation also hurts the public, which loses the benefit of entity level tax revenues from firms that organize as LLCs rather than corporations. Surprisingly, this effective reduction in federal corporate tax revenues did not require passage of a bill, but was instead achieved quietly, through a change in I.R.S. regulations. Similarly, state LLC legislation has been advanced not as a way to reduce business’ share of taxes, but as a way to limit firms’ liability, effectively downplaying the tax impact.

See, e.g., Kontzer, supra note 13, at 3 ("Strong opposition from the California Trial Lawyers Association prevented the [LLC] law from applying to professional service corporations, such as law and accounting firms."). In Texas, critics dubbed the original LLC legislation the “help a lawyer bill.” Weidlich, supra note 48, at 1. The bill passed after it was revised to exclude professionals. Id. However, the lawyers eventually got their way. Texas amended its LLC statute in 1993 to allow professionals to organize under it. Id.

In Washington, plaintiff’s lawyers failed to convince the legislature to require all LLCs to carry a minimal level of insurance. Jessica A. Eaves, A Step in the Right Direction: Washington Passes the Limited Liability Company Act, 18 PUGET SOUND L. REV. 197, 202-03 (1994). However, they succeeded in lobbying the legislature to require Professional LLCs to carry at least a million dollars of insurance. Id.

The plaintiffs’ bar in many states has unsuccessfully opposed passage of LLCs. See, e.g., Eaves, supra note 87, at 200-02 (describing opposition of Washington State Trial Lawyers Association to that state’s LLC legislation).

The situation in Texas is instructive. The plaintiffs’ bar there opposed the passage of a limited liability partnership bill. Weidlich, supra note 48, at 1. However, once the bill passed, they “fell in line” and organized under it. Id.

See infra notes 152-54 and accompanying text.

See supra note 13 and accompanying text.

See supra notes 65-67 and accompanying text.

Members of the business community have argued that no loss in state reve-
Finally, the legislation can be seen as part of the backlash against real or imagined tort excesses. Even if one were to accept that the tort system needs reform, however, the solution would be to reform it, not to exempt whole classes of individuals through a new organizational form.

III. TRADITIONAL JUSTIFICATIONS FOR CORPORATE LIMITED LIABILITY

One of the historic justifications for corporate limited liability is that the corporation is an entity separate from its shareholders. The entity theory makes sense in the context of the large public corporation, where shareholders are passive investors and the corporation is run by managers and a board of directors. While arguably it is unfair to hold passive investors liable for the actions of managers, it is really more fair for the loss to
lie with “passive” tort victims? Accordingly, the entity theory makes less sense as one moves away from the model of the large public corporation.\(^9\) In what way is a member-managed LLC, where there is a unity of ownership and control, an entity separate from its members? If LLC members maintain control, it seems fair to hold them liable for the actions of the organization.\(^{10}\)

Meanwhile, the two-tier tax structure of the corporation flows from the entity concept.\(^{11}\) If the liability of the shareholder and the corporation are separated because the corporation is a separate entity, then logically the corporation should be taxed separately from the shareholder. Business forms such as the S-corporation, the limited partnership, and most recently the LLC, maintain the entity distinction for liability but not for taxation. This inconsistency allows investors to have their cake and eat it too. Entity treatment should be uniform on the issues of taxation and liability—if a firm gets the benefit of limited liability, it should bear the burden of entity level taxation.\(^{12}\)

A related theory of the corporation describes characteristics such as limited liability and continuity of life as privileges granted by the state.\(^{13}\) Commentators have suggested that because the corporation benefits from state privileges, it has a duty to operate in a socially responsible fashion.\(^{14}\) This would argua-

\(^9\) See Mitchell, supra note 25, at 1168 (arguing that entity theory’s “applicability to the close corporation is historically suspect”); see generally Blumberg, supra note 15, at 623-26 (criticizing application of limited liability to shield parent corporations from liabilities of subsidiaries they control).

\(^{10}\) Several commentators express this idea with regard to shareholders of close corporations. See, e.g., Mitchell, supra note 25, at 1184 (stating that “determining factor should be whether control and ownership in a particular form of organization are separated to a sufficient degree that protection of the owners’ individual wealth from the mistakes of management seems fair as well as economically sound”).

\(^{11}\) Ribstein, supra note 1, at 452 (noting that one rationale offered for double taxation is that “a corporation is regarded as inherently an entity that should be treated separately from the members for tax purposes,” but author disagrees with this proposition).

\(^{12}\) But see Ribstein, supra note 1, at 452 (noting that partnerships have many entity features and yet are not subject to double taxation).

\(^{13}\) See Mitchell, supra note 25, at 1160 (entity theory has “long tradition in common-law jurisprudence”); see also Presser, supra note 26, at 1-6.

Many state legislatures were at first willing to grant the privilege of limited liability only to corporations that served a public purpose, such as banks and corporations formed to build turnpikes and toll bridges. Dodd, supra note 69, at 1352. They were unwilling to give the privilege to industrial corporations. Id.

\(^{14}\) See generally Lewis K. Solomon & Kathleen J. Collins, Humanistic Econom-
bly include supporting the public treasury. In *Flint v. Stone Tracy Co.*, the Supreme Court adopted the “privilege theory” which holds that the privileges granted to corporations justify the state’s levying of a corporate tax. The LLC, like the corporation, is a beneficiary of state privileges. Yet it is a creature of which the state has asked little in the way of social responsibility or tax revenues.

Modern theorists of the corporation dispute the idea that incorporation is a privilege granted by the state. They argue that corporate characteristics, such as limited liability, can be achieved by contract, without incorporation, and that incorporation is merely an efficient way of achieving those characteristics. These theorists focus on the benefits society receives from corporate limited liability. One such benefit is the efficient functioning of capital markets; another is broad participation in those markets. Both are discussed below.

Building on the work of earlier writers, Frank Easterbrook and Daniel Fischel suggest that limited liability plays a role in the functioning of capital markets. With a rule of unlimited liability, they argue, investors would be afraid to diversify because

---

105 220 U.S. 107, 162 (1911) (cited in Ribstein, supra note 1 at 453).
106 Id. But see Ribstein, supra note 1, at 453 (stating that there is “no reason to believe that the corporate tax properly measures the value of any benefit from corporate features”).
107 See supra notes 65-96 and accompanying text.
108 See, e.g., Ribstein, supra note 1, at 454 (arguing that businesses could achieve most corporate characteristics by contract, without benefit of state statute).
109 E.g., Posner, supra note 25, at 506 (“[T]he primary utility of corporation law lies in providing a set of standard, implied contract terms, for example, governing credit, so that business firms do not have to stipulate these terms anew every time they transact, although they could do so if necessary.”).

It is true that limited liability can be created by contract in certain situations. In other situations, however, such as where tort victims have not dealt with the corporation, limited liability cannot be achieved by contract. Furthermore, public policy restricts liability disclaimers in certain situations, such as those involving consumers, see, e.g., U.C.C. § 2-719(3) (1995) (“Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable.”).

110 See, e.g., Easterbrook & Fischel, supra note 16, at 97 (“Both those who want to raise capital for entrepreneurial ventures, and society as a whole, receive benefits from limited liability.”).

112 Easterbrook & Fischel, supra note 16, at 92 (“Limited liability makes markets possible.”).
each additional holding, no matter how small, could expose them to disastrous losses.\textsuperscript{113} Furthermore, unlimited liability would require investors to monitor companies more closely because of the increased risk of liability to shareholders.\textsuperscript{114} Large public corporations are only possible because specialized managers act as agents for shareholders. A rule of unlimited liability would increase the cost of specialization by increasing the need for shareholders to monitor those agents.\textsuperscript{115} In addition, owners would be forced to monitor other shareholders’ wealth to measure their own exposure.\textsuperscript{116} Shares could not trade at a single market price because the investor’s wealth would be a factor in the share price. The wealthier the investor, the greater the risk associated with the shares. Thus a wealthier investor would place a lower value on the shares.\textsuperscript{117}

Because of the advantages of limited liability, Easterbrook and Fischel theorize that if statutes did not provide for it, firms would create it by contract.\textsuperscript{118} Thus, statutory limited liability reduces transaction costs.\textsuperscript{119}

As the authors demonstrate, the justifications for limited liability have reduced relevance outside the context of a large public corporation.\textsuperscript{120} In smaller firms owners are more likely to

\textsuperscript{113} Id. at 90 (relying on Manne, supra note 111). But see Presser, supra note 25, at 159 (arguing that shareholders would not be discouraged from investing in regime of unlimited liability because “with large numbers of shareholders the risks to any one investor seem rather small”).

\textsuperscript{114} Easterbrook & Fischel, supra note 16, at 90.

\textsuperscript{115} Id. at 94. The authors recognize that a certain amount of monitoring is inevitable where management is separated from ownership. However, they believe these agency costs are lower in a regime of limited liability. Id. But see Presser, supra note 25, at 159 (suggesting shareholders would adopt strategies for monitoring in regime of unlimited liability rather than foregoing investment).

\textsuperscript{116} Easterbrook & Fischel, supra note 16, at 92 (summarizing work of Halpern).

\textsuperscript{117} Id. But see Presser, supra note 25, at 159 (arguing that limited liability does not play important role in decision to invest because investors only commit money to venture they believe will succeed, not one they think will fail).

Historically, it was argued that limited liability was necessary for free transferability of shares. See Dodd, supra note 69, at 1368 (citing Massachusetts’ Governor Lincoln’s contention that state’s unlimited liability deterred investment).

\textsuperscript{118} Easterbrook & Fischel, supra note 16, at 93.

\textsuperscript{119} Id.

\textsuperscript{120} The authors observe the inappropriateness of extending limited liability to the close corporation.

In close corporations, there is much less separation between management and risk bearing. This has profound implications for the role of limited liability. Because those who supply capital in close corporations typically are also involved in decisionmaking, limited liability does not reduce monitor-
run the business. As a result, under a rule of unlimited or personal liability, there are few added costs associated with monitoring.\textsuperscript{121} Additionally, diversification does not play a major role in the capitalization of small, owner-managed firms. Finally, because these firms are not publicly traded, the need for a uniform market price is reduced.\textsuperscript{122}

Most often, limited liability companies will resemble close corporations.\textsuperscript{123} One of the primary advantages of the LLC is that, like the close corporation, it allows owners to manage without sacrificing limited liability.\textsuperscript{124} Because many LLCs will be owner-managed, however, they will not benefit from the reduced need to monitor provided by limited liability. Likewise, to achieve pass-through taxation, an LLC cannot be publicly traded,\textsuperscript{125} so the form neither benefits from, nor requires, a uniform share price. Thus, theories that rely on the usefulness of limited liability to the capital markets cannot provide a rationale for allowing members of limited liability companies to externalize their costs.

The ideas of Stephen Presser may be of more use to the
advocates of LLCs. Contrary to Easterbrook and Fischel, Presser argues that limited liability is most beneficial in the small-firm context. He believes that individuals of moderate means require the protection of limited liability more than those who are wealthy, because the former can least afford personal losses. Presser points out that the nineteenth century limited liability incorporation statutes were passed in part to democratize opportunities for enrichment. Legislative and judicial pronouncements support the idea that limited liability was created with small investors in mind. Limited liability encouraged small investors to participate in industrial development by allowing them to form manufacturing associations without "any responsibility beyond the amount of the individual subscriptions." It has been suggested that widespread participation in capital markets was critical for American industrialization because the wealth of the capitalist class was limited. Thus, limited liability both democratized and encouraged economic development.

Many LLCs are the small firms that Presser believes most need the protection of limited liability. Yet the use of limited liability to protect investors who would otherwise be unwilling to put their personal assets at risk has been criticized for "artificially support[ing] marginal business ventures at the expense of their creditors." Furthermore, creditors often require personal guarantees from shareholders in close corporations, effectively contracting around the rule of limited liability. There is no reason to believe creditors will not require similar guaran-

---

125 Presser, supra note 25, at 163 (noting that "limited liability ought to be most sacred for smaller firms, and not those possessing great economic wealth").
127 Id. at 156 ("Without limitations on individual shareholder liability, it was believed, only the very wealthiest men ... could possess the privilege of investing in corporations."); see also Dodd, supra note 69, at 1372 (suggesting that, after 1830, availability of limited liability charters in Massachusetts encouraged small business owners to invest).
123 Id. at 155-56.
124 Id. at 155 (quoting Slee v. Bloom, 19 Johns. 366, 474 (N.Y. 1822)).
125 Id. at 155-56 and n.31.
126 Id. at 153. For the view that limited liability currently plays a role in encouraging investment, see Posner, supra note 25, at 502.
123 Mitchell, supra note 25, at 1172.
124 Id. at 1176; see also Halpern et al., supra note 18, at 135 ("[F]or small companies with limited liability creditors often require personal guarantees. This converts the limited liability company into one with unlimited liability.").
tees from LLC members, thereby making the rule of limited liability inefficient for LLCs, because transaction costs would be increased by having a default rule that is varied in the majority of cases. Only tort victims and creditors lacking bargaining power would be unable to contract around the rule. Similarly, while the stated rationale for passage of the LLC legislation has been to stimulate economic investment, commentators have questioned whether limited liability has any effect on overall investment. The idea that limited liability was necessary for industrialization begs the question whether limited liability has outlasted its usefulness, a subject explored more fully in Part IV.

Another argument advanced in favor of limited liability is that creditors are more efficient risk bearers than shareholders. In large public corporations, creditors are often in a better position than shareholders to evaluate risks and to charge an appropriate interest rate (or premium) to compensate for the risk. This is not the case in small firms. Members of an LLC who manage the business will know more about the business than creditors. As a result, they will be in a better position to assess risks associated with the business than creditors, and should be more efficient risk bearers.

Finally, commentators have suggested that the procedural difficulties involved in collecting judgments from large numbers of shareholders make limited liability the only feasible rule.

---

132 See Meiners et al., supra note 25, at 352 ("limited liability, compared to any other rule, makes little difference in the allocative outcome in the market for loanable funds"); see also Mitchell, supra note 25, at 1172 (stating that "limited liability makes little, if any, difference in the decision of small business persons to incorporate").

133 See Dodd, supra note 69, at 1351 ("An important phase of the early development of American manufacturing enterprise was the yielding on the part of one legislature after another to the demands of American manufacturers for limited liability."); see also Blumberg, supra note 15, at 592 (noting how industrialists pressed for limited liability).

134 See infra notes 168-85 and accompanying text.

135 Posner, supra note 25, at 502 ("It may be easier and hence cheaper for the bank to appraise the risk of a default and the resulting liability than it would be for the shareholder, who may know little or nothing about the business in which he has invested.").

136 Id.

137 See Mitchell, supra note 25, at 1175-76 (arguing that creditors are not more efficient risk bearers than close corporation management).

138 See, e.g., Meiners et al., supra note 25, at 363 ("bringing a single action against a multitude of shareholders, in the case of a publicly held corporation, would
Limited Liability Companies

1996

Widely disbursed shareholders create jurisdictional problems.\(^{142}\) When shares are transferred an issue arises as to which shareholders should be held liable.\(^{143}\) Since LLCs are unlikely to be widely traded, however, neither jurisdictional problems nor the transfer of shares should present obstacles in reaching assets of individual members.

IV. CRITICISMS OF LIMITED LIABILITY

Limited shareholder liability has been criticized for creating disincentives for corporations to capitalize adequately,\(^{144}\) to insure properly,\(^{145}\) or to operate safely.\(^{146}\) Entities protected by limited liability can engage in risky behavior knowing that while probably generate litigation costs higher than most creditors would be willing to pay\(^{147}\); Note, supra note 18, at 1198 (commenting that "the practical problems would be immense" when collecting judgments from large numbers of shareholders).


\(^{143}\) See, e.g., Gabaldon, supra note 25, at 1448 ("When, for instance, would liability attach? At the time of injury? The time of discovery? The time a claim is made?"). Dodd has observed, however, that in the early nineteenth century, Massachusetts, which required personal shareholder liability in manufacturing corporations, experimented with various rules and finally settled on liability for those who held the shares at the time of contracting. See Dodd, supra note 69, at 1365; see also Hansmann & Kraakman, supra note 15, at 1899-1901 (discussing why costs of collection would not be prohibitive).

\(^{144}\) See, e.g., Hansmann & Kraakman, supra note 15, at 1917 (criticizing limited liability regimes that allow: "shareholders ... who benefit ... from intentional dumping of toxic wastes, from marketing hazardous products without warnings, or from exposing employees without their knowledge and consent to working conditions known by the firm to pose substantial health risks ... to avoid the resulting costs simply by limiting the capitalization of their firm"). Id.

Although under-capitalization is one factor courts consider in deciding whether to pierce the corporate veil, that alone will not usually result in shareholders being held personally liable. See Note, supra note 18, at 1193-94. But see Ribstein, supra note 1, at 441 (arguing that large voluntary creditors will "insist on adequate capitalization").

\(^{145}\) Halpern et al., supra note 18, at 145 (noting that "there is no incentive for the owner to carry adequate insurance since, in the event of default, there is no cost to the owner"); Hansmann & Kraakman, supra note 15, at 1889 (noting tendency of limited liability firms to underinsure). But see Ribstein, supra note 1, at 440-41 (arguing that, notwithstanding limited liability, shareholders will insure to protect their investment in firm).

\(^{146}\) See Hansmann & Kraakman, supra note 15, at 1882 ("most familiar inefficiency created by limited liability is the incentive it provides for the shareholder to direct the corporation to spend too little on precautions to avoid accidents"); Note, supra note 18, at 1195 (stating that "shareholder immunity conflicts with the premise of tort liability"). But see Ribstein, supra note 1, at 444-45 (arguing that increasing liability of owners will not effect degree of care exercised by agents).
the owners' full benefit of success accrues, the cost of failure can be shifted. This "moral hazard" is even greater for entities such as LLCs in which owners manage.\textsuperscript{147} Owners, more than corporate agents such as directors or officers, benefit directly from the externalization of risk.\textsuperscript{148} Owners have a greater incentive to undercapitalize\textsuperscript{149} (because it minimizes their exposure) than do agents (who are not risking their own capital) or partners (who are fully personally liable). They are also more likely to underinsure (because the premiums come out of their pockets and their personal assets are protected) than either agents (who do not pay the premiums) or partners (who are personally liable).

Lawrence Mitchell has advanced another argument against limited liability for an entity with unity of ownership and control.\textsuperscript{150} Taking the partnership as the paradigm of such an entity, Mitchell suggests that because a partner can bind the partnership without the benefit of deliberation by a board of directors, personal liability is necessary to insure that the partner acts prudently.\textsuperscript{151} What is there to insure that LLC members, who can likewise bind the LLC, act prudently? What will provide a deliberative process in these new entities?

Notwithstanding the implications of encouraging companies to engage in socially irresponsible behavior, many states have passed limited liability company statutes. These statutes have not surprisingly been touted as the ideal business form for high-risk ventures.\textsuperscript{152} To the entrepreneur they are indeed ideal because someone else is bearing part of the risk. That someone else may be a person injured by a company product or byproduct, or a trade creditor who dealt with the company, or both.

\textsuperscript{147} Thompson, \textit{supra} note 15, at 27 ("When there is an overlap of management and shareholding, there exists the greatest chance that decisions are being made to externalize costs."); \textit{see also} Easterbrook & Fischel, \textit{supra} note 16, at 110 ("suggesting that incentive created by limited liability for managers to undertake overly risky projects is much more severe in close corporations"); Halpern et al., \textit{supra} note 18, at 145.

\textsuperscript{148} See Halpern et al., \textit{supra} note 18, at 141 (noting that "moral hazard problem is likely to be more severe for small, tightly held companies ... because the owners ... have a direct interest in the operations of the firm").

\textsuperscript{149} This is true not only for a closely held corporation owned by individual shareholders, but also for a subsidiary corporation controlled by a parent corporation. \textit{See generally} Blumberg, \textit{supra} note 15.

\textsuperscript{150} Mitchell, \textit{supra} note 25, at 1180-81 (examining problem of limited liability in context of close corporations).

\textsuperscript{151} \textit{Id.} at 1181-82.

\textsuperscript{152} \textit{See supra} notes 53-56 and accompanying text.
Many commentators have recognized the unfairness of limited liability in the tort context. Unlike contract creditors, tort victims often cannot contract around limited liability or charge higher prices or interest rates to compensate for the additional risk. Modern technologies that greatly increase the risks of massive tort injuries compound the problem.

Richard Posner, a strong advocate of limited liability in the contract arena, has suggested remedying the unfairness to tort victims by requiring corporations engaged in dangerous activities to post a bond equal to the highest likely tort damages. Other scholars have proposed unlimited pro rata shareholder liability for corporate torts. LLC statutes, however, do not provide either these or similar protections for tort victims. To the contrary, firms organize as LLCs specifically to shield owners from tort claims. Yet the risk to tort claimants is far greater from smaller, more thinly capitalized firms such as LLCs, than from large public corporations which will usually have sufficient assets to pay claimants.

A certain level of cost externalization might be justified if the benefits society received from limited liability outweighed

---

153 Hansmann & Kraakman, supra note 15, at 1880 (“arguing that limited liability in tort cannot be rationalized for either closely-held or publicly-traded corporations”); Note, supra note 18, at 1190-91 (“Corporations owned by affluent shareholders, yet too impoverished to meet their tort liabilities, are the inevitable product of present-day incorporation laws.”); see also Halpern et al., supra note 18, at 145 (noting concern “with the potential for owners of a limited liability corporation to effect uncompensated transfers of the risk of business failure to [involuntary creditor]”; Posner, supra note 25, at 520 (advocating system of mandatory bond for companies engaged in dangerous activities).

154 They have had no dealings with the company prior to being injured. See Meiners et al., supra note 25, at 359, 365.

155 See Hansmann & Kraakman, supra note 15 at 1880 (cataloging some sources of risk, including environmental harms and hazardous products).

156 Posner, supra note 25, at 520.

157 See generally Hansmann & Kraakman, supra note 15, (suggesting regime of pro rata shareholder liability for corporate torts).

158 See, e.g., Keatinge et al., supra note 1, at 408 (noting that even where personal guarantees of members are desirable because they reduce credit costs, LLC allows members to give those guarantees and still shield themselves from tort liability).

the harm caused to its victims. Yet a number of commentators dispute the idea that limited liability makes any positive economic contribution at all. Historical studies have raised doubts about whether limited liability was necessary for industrial development or whether it plays a role in the efficient functioning of capital markets. Scholars have also questioned whether limited liability reduces transaction costs or decreases monitoring by shareholders. A suggested alternative to limited liability is insurance which provides the same benefits for capital markets but does not externalize the cost of doing business. It

160 But see Note, supra note 18, at 1196 (suggesting that if society benefits from limited liability, society, not tort victims, should pay cost).
161 See generally Meiners et al., supra note 25, at 352 (arguing that limited liability is not critical to corporate form).
162 Dodd notes that in the early Nineteenth Century, personal liability provisions in manufacturing charters did not “prevent large numbers of Massachusetts industrialists from seeking incorporation.” Dodd, supra note 69, at 1364. Although Massachusetts began offering limited liability charters in 1830, there was not an “immediate acceleration” in the number of manufacturing corporations. Id. at 1371; see also Meiners et al., supra note 25, at 362. Dodd also observes that Massachusetts granted more manufacturing charters than neighboring states, during a period when it required personal liability and neighboring states granted limited liability. Dodd, supra note 69, at 1368. However, Dodd believes that eventually a lack of limited liability would have retarded growth. Id. at 1378.
163 See generally Grossman, supra note 25. Grossman examined the market for shares of the American Express Company in the 1950s. At the time, the company was an unlimited liability joint stock association and shareholders had pro rata unlimited liability. Id. at 73. According to the study, the shares provided a good rate of return, were widely traded, and the share price did not vary according to the wealth of the shareholders. Id. at 75-77. Grossman concludes that “in general, the view that limited liability is a necessary condition for the functioning of stock markets is refuted.” Id. at 66. But see Dodd, supra note 69, at 1372 (noting that limited liability charters may have increased marketability of shares).

Other scholars have questioned to what degree unlimited liability would deter investors. For the argument that investors buy stock in companies they believe will succeed, not fail, thus reducing the importance of the issue of liability to the decision to invest, see Presser, supra note 25, at 159.
164 See Meiners et al., supra note 25, at 360 (“Since bargaining in credit markets is typically conducted in negotiated transactions, we expect that the costs of bargaining will be roughly equivalent with or without limited liability.”). The authors also note that standard form contracts could easily incorporate language limiting liability. Id. at 364.

166 See id. at 363 (maintaining that share price already contains “all the information, aside from undisclosed inside information, that investors need”); Presser, supra note 25, at 159 (suggesting methods by which shareholders could monitor cheaply).
166 See Easterbrook & Fischel, supra note 16, at 101-03 (discussing insurance as alternative to limited liability); Halpern et al., supra note 18, at 129 (observing “similarities between an unlimited liability regime with the existence of market in-
has been suggested that if insurance had been generally available in the nineteenth century legislatures might not have adopted corporate limited liability at all.\textsuperscript{167} Additionally, scholars have argued that limited liability is itself a form of insurance, one that shareholders purchase from creditors without a formal insurance contract.\textsuperscript{168}

\textit{Enterprise Liability and the LLC}

Limited liability was not always the rule.\textsuperscript{169} It evolved in response to pressure from manufacturers in the nineteenth century.\textsuperscript{170} In addition to limited liability for corporations, the law developed many other pro-industry doctrines in order to encourage industrial development.\textsuperscript{171} The shift in tort law from strict liability to negligence\textsuperscript{172} and the development of the fellow servant\textsuperscript{173} and contributory negligence\textsuperscript{174} doctrines were other ways

\textsuperscript{167} See Note, supra note 18, at 1196 n.27; see also Halpern et al., supra note 18, at 125-26.

\textsuperscript{168} See, e.g., Halpern et al., supra note 18, at 126 ("limited liability Regime [is] an implicit, creditor-provided form of insurance of the risks of business failure"); Meiners et al., supra note 25, at 361.

Of course this "insurance contract" does not take into account tort victims who neither receive "premiums" (as contract creditors presumably do, charging more for the services they provide than they would in an unlimited liability regime) nor compensation for their injuries.

\textsuperscript{170} See Blumberg, supra note 15, at 587-95 (discussing emergence of limited liability in American law). See generally Dodd, supra note 69 (describing evolution of limited liability in Massachusetts).

\textsuperscript{171} See Blumberg, supra note 15, at 595; see also Slee v. Bloom, 19 Johns. 366, 473-74 (N.Y. 1822) (cited in Mitchell, supra note 25, at 1163 n.77).

\textsuperscript{172} See Gabaldon, supra note 25, at 1439 (briefly discussing emergence of caveat emptor, negligence and other doctrines).

\textsuperscript{173} See MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1780-1860 65 (1977) (reclassification of injuries "under a 'negligence' heading ... had the effect of substantially reducing entrepreneurial liability"); Charles O. Gregory, Trespass to Negligence to Absolute Liability, 37 VA. L. REV. 359, 382 (1951) ("[T]he principle eliminating the unintended trespass as a substantive tort and establishing a consistent theory of liability based on fault was developed to confer on industrial enterprise an immunity from liability for accidental harm to others."); Cornelius J. Peck, Negligence and Liability Without Fault in Tort Law, 46 WASH. L. REV. 225, 250 (1971) ("The negligence standard provided a legal environment in which rail transportation could grow and prosper. It aided other branches of industry and commerce as well."). But see Gary T. Schwartz, Tort Law and the Economy in Nineteenth-Century America: A Reinterpretation, 90 YALE L.J. 1717 (1981) (criticizing Horwitz and Gregory).

\textsuperscript{174} See PROSSER & KEETON ON TORTS (5th ed. 1984) § 80, at 571-72 (describing development of fellow servant doctrine, which limited vicarious liability of employers to their employees, as motivated by desire of courts "to encourage industrial un-
the law protected nascent industry. Yet with the growth of industrial enterprises and the availability of insurance, many manufacturer protections have eroded:176 Strict products liability has replaced negligence;176 contributory negligence has largely been replaced by comparative negligence;177 and the fellow servant doctrine has been abolished as a defense in workers' compensation actions.178 Perhaps limited liability should fade away, rather than being expanded through the adoption of an attractive new business entity such as the LLC?

In the twentieth century, the idea that industry should “assume the burden of paying for all damage ensuing from its normal operations,”179 has replaced the idea that industry requires a subsidy.180 Enterprise liability has several objectives. By forcing industry to internalize all of its costs, it deters overly risky behavior.181 It is also a way of spreading loss.182 Industry
dertakings by making the burden upon them as light as possible”); see also Gregory, supra note 172, at 368.

174 See PROSSER & KEETON, supra note 173, § 65, at 452 (explaining acceptance of contributory negligence doctrine, under which a plaintiff is denied recovery if his or her negligence contributed to harm, as result of desire of courts to “keep the liabilities of growing industry within some bounds”); Peck, supra note 172, at 231 (“concept of contributory negligence as a bar to recovery rose to prominence in response to the need for a legal system compatible with the demands of a growing industrial economy”).

175 See Gabaldon, supra note 25, at 1440 (noting difference in evolution of tort and contract law on one hand, and corporate law, on other).

176 PROSSER & KEETON, supra note 173, § 65, at 694 (citing Greenman v. Yuba Power Prosds., Inc., 59 Cal.2d 57 (1963) and acceptance of Section 402A of Second Restatement of Torts as catalysts for “adoption of strict liability in tort throughout the country”).

177 Id. § 67, at 478-479.

178 Id. § 80, at 573. Furthermore, as the authors point out, workers' compensation acts are strict liability statutes. Id.; see also Gregory, supra note 172, at 388.

179 Gregory, supra note 172, at 382-83; see also George L. Priest, The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law, 14 J. LEGAL STUD. 461, 463 (1985) (“theory of enterprise liability ... provides in its simplest form that business enterprises ought to be responsible for losses resulting from products they introduce into commerce”).

180 See Priest, supra note 179, at 463 (“By the mid-1950s, the theory of enterprise liability commanded almost complete support within the academic community, and it was accepted and implemented as a tool of social policy in the early 1960s ...”). See also Albert A. Ehrenzweig, Negligence Without Fault, 54 CAL. L. REV. 1422, 1455 (1966) (“desire to protect growing industry ... seems outweighed by the wealth of corporate enterprise”). For a history of the growth and acceptance of enterprise liability, see Gregory, supra note 172. Enterprise liability is not without its critics. See generally David G. Owen, Rethinking the Policies of Strict Products Liability, 33 VAND. L. REV. 681 (1980).

181 See Priest, supra note 179, at 478. This has been called the control rationale
can insure against those losses by building into the cost of products foreseeable losses from accidents. Requiring industry to administer this loss-shifting system is equitable since industry profits from the risk creation.

Since shareholders profit from corporate enterprises, it may also be fair to require them to pay the costs of doing business. Yet the deterrence rationale of enterprise liability arguably does not support holding shareholders who do not manage the enterprise responsible for accidents. Members of limited liability companies, however, can manage the enterprise as well as receive the profits of the enterprise. Thus the policies supporting enterprise liability would support requiring individual members of LLCs to assume the risk of accidents.

V. MITIGATING THE HARMFUL EFFECTS OF LLCs

The thrust of this paper has been that limited liability is inadvisable for entities with the organizational characteristics of the LLC. Because powerful interest groups support LLC legislation, however, it is unrealistic to hope for their wholesale repeal. Legislatures must therefore look for ways to mitigate the externalization of costs associated with LLCs.

As discussed above, the passage of LLC legislation creates incentives for firms to engage in overly risky activities without of enterprise liability.


184 Gregory, supra note 172, at 383-84; Priest, supra note 179, at 471. A number of scholars have pointed out that individuals are usually not in as good a position to purchase insurance as the enterprise. See, e.g., Gregory, supra note 172, at 384; Ehrenzweig, supra note 180, at 1447.

185 See Gregory, supra note 172, at 385 (discussing workers’ compensation statutes and noting “homely justics in letting [employers] undertake this burden because they are risk-creating agencies in enterprises conducted for profit”); see also Priest, supra note 179, at 466-67 (describing Francis Bohlen’s “benefit theory” of enterprise liability).

186 See Thompson, supra note 15, at 29-30 (considering proposition that shareholders should be liable for corporate torts on “economic benefits” theory).

187 Thompson, supra note 15, at 4 (arguing that “stronger case can be made to hold ... participants liable for the acts of others as compared to situations in which the individual is only a shareholder without control”). However, the argument could be made that while shareholders may not manage, they do indirectly control the enterprise by electing the board of directors. Furthermore, shareholders who are not satisfied with management decisions can sell their shares, i.e. vote with their feet.
adequate insurance or capitalization.\footnote{187} Tort victims whose injuries exceed firm assets will be hurt most by this behavior. One solution to this problem is to mandate that LLCs carry liability insurance.\footnote{188} Since insurance premiums will be linked to the behavior of companies, the added costs will give companies an incentive to reduce risk.\footnote{189} The insurance proceeds can be used additionally to compensate tort victims who have not agreed to bear risks. Currently, however, no state requires all LLCs to carry insurance.\footnote{190}

Mandatory insurance is superior in some ways to unlimited liability because it is a better guarantee of payment for tort victims if LLC members are judgment proof.\footnote{191} Failure to carry such insurance should result in a court decision to “pierce the veil” of the LLC and hold members personally liable.

Some critics charge that mandatory insurance schemes create regulatory problems and drive up the cost of doing business.\footnote{192} They claim it is too difficult to set appropriate insurance levels for vastly different businesses.\footnote{193} Yet states currently require employers in many of the same businesses to carry worker’s compensation and unemployment insurance. And an increase in the cost of doing business is inevitable if firms are to internalize costs that were previously externalized.

\footnote{187}See supra notes 142-147 and accompanying text.
\footnote{188}This has been attempted in some states. In Washington, for example, plaintiffs’ lawyers lobbied unsuccessfully for mandatory insurance for LLCs. They did succeed, however, in inserting a mandatory insurance provision for professionals that practice in LLCs. See Eaves, supra note 87, at 202-03.

A number of authors have proposed schemes of mandatory insurance for corporations to mitigate the harmful effects of limited liability. See, e.g., Gabaldon, supra note 25, at 1449-54; Note, supra note 18, at 1201-02. But see Halpern, supra note 18, at 138-43 (arguing that unlimited liability is superior to insurance for closely held companies because, for those companies, market-provided insurance may not be available); Ribstein, supra note 1, at 446-47 (criticizing third-party insurance schemes for increasing “the cost of insurance in relation to the expected loss”).

\footnote{190}See Eaves, supra note 87, at 202 (arguing that adoption of amendment to Washington LLC statute mandating insurance would have destroyed “statutory uniformity with states already providing the LLC business form”). Some states do require professionals who organize as LLCs to carry insurance. See infra note 194.

\footnote{191}See Note, supra note 18, at 1201-03 (making this point in proposing mandatory insurance for close corporations).

\footnote{192}Id.

\footnote{193}Id.; see also Gabaldon, supra note 25, at 1449-54 (discussing and refuting this and other criticisms of mandatory insurance schemes).
Some states already require professional LLCs to carry insurance. Do hazardous waste disposal companies, oil and gas companies, and the like, really pose fewer risks to society than professionals? Are those risks less worth insuring against?

It has been suggested that piercing the corporate veil of LLCs will prevent abuses by members. Some statutes expressly mandate the application of the doctrine to LLCs. Yet piercing alone is an insufficient response to the potential harms created by LLCs. Piercing is a less predictable method of compensation for tort victims than insurance, because of the erratic way courts apply the doctrine and, as noted above, because individual members of LLCs may themselves be judgment proof. Piercing cannot provide a deterrent to risk creation the way insurance can because it is applied only after the harm has occurred. Members of LLCs cannot be deterred by a doctrine they may not know about, and whose application is so uncertain.

CONCLUSION

In an end-run around the political process, proponents of LLCs have succeeded in reducing the share of federal taxes paid by businesses without public debate or Congressional vote. They have set the stage for a dramatic increase in the number of businesses protected by a limited liability shield without offering a coherent policy justification for that expansion. The rash of legislation is a response to lobbying by powerful interest groups such as professionals and the oil and gas industry, and is a symptom of “race to the bottom” corporate lawmaking.

1996] LIMITED LIABILITY COMPANIES 607

194 See, e.g., WASH. REV. CODE § 25.15.045(2) (1994) (mandating minimum one million dollar liability insurance for certain professions practicing in LLC form).

195 The piercing doctrine allows courts to “disregard the separateness of the corporation and hold a shareholder responsible for the corporation’s action as if it were the shareholder’s own.” Thompson, supra note 26, at 1036.

196 See, e.g., BISHOP & KLEINBERGER, supra note 13, ¶ 6.03[3], at 6-28 to 6-29. See generally Fox, supra note 27.


198 See Thompson, supra note 26, at 1058 (noting that courts pierce corporate veil only thirty percent of time when asked to do so by tort victims of corporations).

199 See, e.g., Easterbrook & Fischel, supra note 16, at 89 (noting “consensus that the whole area of limited liability, and conversely of piercing the corporate veil, is among the most confusing in corporate law”); Thompson, supra note 26, at 1036-37 (“The boundaries of this exception ... are usually stated in broad terms that offer little guidance to judges or litigants ....”).
Policies supporting limited liability in the corporate context do not support limited liability in an entity such as an LLC where ownership and control are united. Criticisms levied against corporate limited liability apply even more forcefully against such entities: LLCs will encourage business owners to undercapitalize and underinsure, while discouraging efforts to reduce risks.

Legislatures should not have rushed to pass LLC statutes without more study and debate. Yet it seems unlikely that the genie can be put back in the bottle. Thus legislatures must look for a way to reduce the social harms that LLCs will likely cause. Since those most harmed by LLCs will be uncompensated tort victims, legislatures should mandate that all LLCs, not just those operated by professionals, carry sufficient liability insurance.

Rachel Maizes