# LIMITED LIABILITY COMPANIES: EMERGING TRENDS IN VEIL PIERCING

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## I. INTRODUCTION

In 1926, Judge Cardozo opined that veil piercing is a doctrine "still enveloped in the mists of metaphor."[1] Today, the doctrine is "lost in a fog"[2] still shrouded by a veil that some scholars wish to tear down.[3] Some scholars still staunchly defend the doctrine[4] while some still strive to reform it.[5] With the enactment of limited liability company (LLC) statutes in all 50 states, Cardozo's mist has now spread over the limited liability landscape. The indeterminacy attributed to the broad discretion exercised by the courts in the application of the "tests of fairness and justice"[6] to the LLC veil piercing has spawned the same debate and uncertainty that it has generated in corporate law since Cardozo's oft-quoted metaphor.

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

2. *See* John Matheson & Raymond 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, 150 (2000).

3. *See, e.g.*, Stephen Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479 (2001); Stephen Bainbridge, *Abolishing LLC Veil Piercing, Symposium: Uncorporation: A New Age?*, 2005 U. ILL. L. REV. 77. ("Abolishing veil piercing would refocus judicial analysis on the appropriate action – did the defendant-LLC member do anything for which he or she should be held directly liable?"); *see also* Henry Hansmann & Reiner Kraakman, *Toward Unlimited Shareholder Liability for Corporate Tort*, 100 YALE L.J. 1879 (1991), advocating abolition of limited liability.

4. *See* Geoffrey Christopher Rapp, *Preserving LLC Veil Piercing: A Response to Bainbridge*, 31 J. CORP. L. 1063 (2006); Michael Coffey, *In Defense of Limited Liability – A Reply to Hansmann and Kraakman*, 1 GEO. MASON L. REV. 59 (1994).

5. *See e.g.* Jeffrey Vandervoort, *Piercing the Veil of Limited Liability Companies: The Need for a Better Standard*, 3 DE PAUL BUS. & COM. L. J. 51 (2004); Rebecca Huss, *Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 CIN. L. REV. 95 (2001); and Matheson & Eby, *supra* note 2.

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

It is said that the doctrine of "piercing the corporate veil" is entirely a matter of case law.[7] Thus, *Kaycee Land & Livestock v. Flahive*[8] held that:

> (t)he concept of piercing the corporate veil is a judicially created remedy for situations where corporations have not been operated as separate entities as contemplated by statute and, therefore, are not entitled to be treated as such. The determination of whether the doctrine applies centers on whether there is an element of injustice, fundamental unfairness, or inequity. The concept developed through common law and is absent from the statutes governing corporate organizations.[9]

Ironically, while corporate veil piercing was conceived in the courts and evolved by judicial fiat, it has now been transplanted in the LLC arena by state enabling acts that, by explicit reference or clear implication, have lent the corporate doctrine statutory basis. Minnesota's LLC statute, for example, typifies this by providing that "case law that states the conditions and circumstances under which the veil of a corporation may be pierced under Minnesota law also applies to limited liability companies."[10]

This paper attempts to identify emerging trends in LLC veil piercing at the statutory and jurisprudential levels, to trace the historical origins of the LLC piercing doctrine, and to speculate on the general direction that departure from conventional corporate veil piercing principles is likely to take. By way of background, a review of the origins of the LLC will be helpful.

## II. PROVENANCE OF THE LIMITED LIABILITY COMPANY

The LLC business entity form may be traced to the German limited entity established by law in 1892 called *Gesselschaft mit beschrankter Hafting* (GMBH).[11] The German success with the GMBH fueled a flurry of

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[7] *See* CARTER BISHOP & DANIEL KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW, ¶ 6.03 (2006).

[8] 46 P3d 323 (Wy. 2002).

[9] *Id.* at 326.

[10] Minn. Stat. Ann., § 322 B. 303; *see also* Huss, *supra* note 5, at 116-119.

[11] *See* William Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855 (1995).

activity in commercial law reform such that in rapid succession, similar laws were enacted in the following countries: Portugal (1917), Brazil (1919), Chile (1923), France (1925), Turkey (1926), Cuba (1929), Argentina (1932), Peru (1936), Colombia (1937), Costa Rica (1942), Guatemala (1942), and Honduras (1950). Entities similar to the LLC are now common throughout Europe and Latin America.[12]

It is, however, also claimed that the origins of LLC statutes were the partnership association statutes enacted by some states in the 1800s,[13] and that the American LLC is an original creation based on an amalgam of English and American partnership law, since European LLCs lacked the contractual freedom of their American counterparts.[14] While there is some dispute as to the true intellectual origins of the LLC,[15] state legislatures explicitly sought to create a form similar to the GMBH, the Portuguese *sociedate por quotas responsibilidade limitada*, and the Latin American *limitada*. Thus, Wyoming's LLC was enacted to form a business vehicle similar to the Panamanian *limitada*. The Florida legislature specifically discussed how the LLCs empowered by its statute were similar to the Central and South American *limitada*.[16]

In the United States, Wyoming enacted the first LLC statute in 1977, although it was not an immediate success due to conflicting taxation regulations. In 1988, however, the U.S. Internal Revenue Service issued

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[12] *See* Steven Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43,46 (1994) *citing* FRIEDMANN & KALMANOFF, JOINT INTERNTIONAL BUSINESS VENTURES 214, 216-217 (1961) and WILLIAM BAGLEY & PHILIP WHYNOTT, THE LIMITED LIABILITY COMPANY: THE BETTER ALTERNATIVE, 1.502 - .503 (1991). The enabling statutes in these countries generally provide, in addition to limited liability, the following distinctive characteristics: (1) use of the word "limited" in the entity's name; (2) juridical personality; (3) the partnership concept of "delectus personae," and (4) death of a member as an event of dissolution (*see* Eder, *Limited Liability Firms Abroad*, 13 UNIV. PITT. L. REV. 193 (1952).

[13] *See* Charles Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. L. 499 (2001). These included Pennsylvania, Michigan, New Jersey, and Ohio; Wayne Gazur & Neil Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 393 (1990); Robert Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. L. 375, 381 (1992).

[14] *See* Carney, *supra* note 11, at 877.

[15] *See* David 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, 468 (1998).

[16] Rapp, *supra* note 4, at 1079; Carney, *supra* note 11, at 861; Carol Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193, 1201 (1995) ("The committee reports discussing LLCs specifically noted that LLCs were similar to a form of business organization prevalent in Central and South America. . . .")

Revenue Ruling 88-76 recognizing that an LLC could be classified as a partnership for tax purposes and as a result there came a flood of LLC organizations. LLCs are now authorized by statute in all states.[17]

State LLC statutes considerably vary but LLCs generally share certain characteristics: (1) all LLCs are formed upon the filing of an organizational document called articles of organization; (2) the owners are referred to as members rather than shareholders or partners; (3) in most jurisdictions, there must be at least two members in order to operate an LLC; and (4) the internal affairs of the LLC are managed in accordance with either (a) the statutory default rules, (b) with an operating agreement, or (c) internal regulations whose contents are agreed to by the members.[18] Usually, the default rules provide for management by the members of the LLC, but in most cases the LLC can elect to be managed by designated managers, who may or may not be members. Owners can contribute cash or property, and usually services to the LLC, in return for their membership interests.[19] Absent agreement to the contrary, the owners have no personal liability for debt incurred by the LLC.[20]

Because of the characteristic statutory advantages enjoyed by LLCs, particularly the unique combination of tax benefits with limited liability and management flexibility, LLCs are becoming an organizational form of choice for small enterprises and many closely held businesses.[21]

Indeed, the LLC phenomenon has turned into a "silent" revolution in the United States, with LLCs comprising 45% of new businesses.[22] As of 2002, 946,000 LLCs had been formed under the new state LLC statutes

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[17] *See* Murdock, *supra* note 13, at 499. *See also* Bahls, *supra* note 12, at 47 ("Before 1986, only two states, Wyoming and Florida, had enacted limited liability legislation, probably because much doubt existed as to whether limited liability companies would receive the benefit of taxation as partnerships. In 1988, the internal revenue service provided needed clarification by releasing revenue ruling 88-76, which stated that properly structured Wyoming limited liability companies would be taxed as partnerships. The revenue ruling settled many doubts about the future of limited liability companies and broke the way for other states to begin legislation in this area.").

[18] *See* Goforth, *supra* note 16, at 1207-1208.

[19] *Id.*

[20] *Id.*

[21] Professor Larry Ribstein, the Reporter for the ABA Prototype Limited Liability Company Act, predicts that "the partnership form of business will greatly diminish in importance . . . after a transitional period, partnership will survive if at all, as a residual form for firms that have no customized agreement." Quoted in Bahls, supra note 12, at 49.

[22] Howard Friedman, *The Silent LLC Revolution — The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 35 (2004).

while the number of general partnerships declined by 25%. The period from 1996-2002, saw the number of LLCs increase by more than 400% (from 221,000 in 1996). By 2002, LLCs outnumbered partnerships, and while corporations were still more numerous, LLCs dominated new filings in some states, and nationwide, 45% of new business filings were LLCs.[23] A more recent 2004 survey disclosed that the usage of LLCs has grown considerably over the last few years, and except for New York, LLC and limited liability partnership filings in the states now exceed corporate filings.[24]

## III. CONCEPT OF LIMITED LIABILITY

Limited liability invites a discussion of a legal doctrine characterized by antipodal objectives: immunity from, as opposed to, exposure to risk of liability- concepts metaphorically described as "shield of protection" against "piercing of the veil." Both corporate law and LLC law provide that equity holders are, as a rule, not personally liable for corporate or entity obligations. With particular respect to LLCs, pursuant to LLC statutes in force in all the 50 states, an LLC member or manager is immune from liability for the debt, obligation or liability of the company solely by reason of being or acting as a member or manager.[25] The debts, obligations and liabilities of an LLC whether arising in contract, tort or otherwise are solely those of the LLC.[26]

The LLC is a statutorily created entity wherein members enjoy a limited liability protection, akin to that provided to corporate shareholders, and the management flexibility and pass-through tax treatment accorded to

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[23] Rapp, *supra* note 4, at 1068.

[24] Sandra Miller et al., *An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609, 618 (2006).

[25] *See* 11 LARRY RIBSTEIN & ROBERT KEATINGE, LIMITED LIABILITY COMPANIES, Appendix 12-2 (2006) (citing references to pertinent provisions of all state LLC statutes).

[26] Uniform Limited Liability Company Act of 1996, § 303[a]. One author has observed that the term "limited liability" is a misnomer, because the shareholder in the case of a corporation or the member in the case of an LLC has in fact no liability for obligations of the entity, unless it is understood to implicate the possibility of piercing which thus impliedly renders the liability limited. BISHOP & KLEINBERGER, *supra* note 7, n.6.

general partners in a partnership. It has thus been described as a hybrid between corporations and partnerships.[27] Thus:

> The allure of the limited liability company is its unique ability to bring together in a single business organization the best features of all other business forms — properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership.[28]

### A. RATIONALE FOR LIMITED LIABILITY

As stated above, a corporate shareholder or member of an LLC enjoys limited liability in respect of his investment, which means that he is not liable for the debts and obligations of the enterprise. In practical effect, limited liability refers to the ability of a shareholder or interest holder of an LLC to risk only the capital that such individual invests or has agreed to contribute in the entity.[29]

Limited liability was invented, among other objectives, to: (1) encourage economic expansion through investment (the "Economic Theory"), and (2) democratize wealth or the opportunity to accumulate it (the "Democratic Theory").[30] Capital-intensive businesses require substantial amounts of capital and one way to attract capital is to assure investors that they could invest without risking all their personal assets. With limited liability, owners are set free to invest in various business ventures without the need to incur the excessive costs necessary to monitor each enterprise closely.[31]

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[27] *See generally* Cohen, *supra* note 15, at 452; *see also* Fredric Bendremer, *Delaware LLCs and Veil Piercing: Limited Liability has its Limitations*, 10 FORDHAM. J. CORP. & FIN. L. 385 (2005).

[28] *See* PB Real Estate, Inc. v. DEM II Properties, 719 A. 2d 73, 74 (Conn. App. Ct. 1998), *citing* Unif. Ltd. Liab. Co. Act, prefatory vote, 6A U.L.A. 426 (1995).

[29] Vandervoort, *supra* note 5, at 53; *see* Model Business Corp. Act, Sec. 6.22(b) (1885). This principle has been accepted since the mid-nineteenth century. *See also* Robert Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1039 (1991). Such limited liability has not always been the role in American Law; *Id. citing* Phillip Blumberg, *Limited Liability and Corporate Groups*, J. CORP. L.573, 587-91 (1986) (describing early American law providing for shareholder liability).

[30] Cohen, *supra* note 15, at 442-444.

[31] *See* Vandervoort, *supra* note 5, at 564; *see also* STEPHEN PRESSER, PIERCING THE CORPORATE VEIL, § 1:7 (2006) (analyzing law and economics scholars' arguments from the perspective of convenience).

Economic efficiency is also advanced to justify limited liability. In their book, *The Economic Structure of Corporate Law*, Easterbrook and Fischel theorize that limited liability reduces the transaction costs associated with the separation of agents and owners of capital and enhances the efficient and smooth running of the securities markets, for the following reasons:

> (1) Reduction of monitoring costs of agents - limited liability reduces the entity's and its shareholders' need to monitor its agents, which makes passive investing and diversification a more rational strategy, reducing the costs of operating the entity;
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> (2) Reduction of monitoring costs of co-investors - limited liability reduces the need to monitor other shareholders to see whether they can properly bear the risks that the entity plans or is undertaking;
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> (3) Efficient share transferability - limited liability promotes the free transfer of shares, which creates incentives for managers to act efficiently since the results of their inefficient actions will be punished by the market;
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> (4) Market information efficiency - limited liability makes shares homogenous commodities that reflect all the information publicly available about the entity, allowing trading on the same terms and ensuring investors that the price reflects all available information;
>
> (5) Asset diversification - limited liability allows for more efficient diversification of one's assets because investors would not be under constant fear of losing all their wealth should they invest in too many ventures; and

(6) Optional management - limited liability prevents managers from becoming unduly risk-averse.

Thus, the limited liability feature of an investment causes certain behavioral and motivational changes that are seen to further economic progress.[32]

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[32] Vandervoort, *supra* note 5, at 54-56, *citing* EASTERBROOK &FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 4 (1991).

The democratic theory, on the other hand, argues that limited liability allows small investors opportunity to invest without fear of losing more than the amount of their original investment, thus providing democratic access to capital and investment. Whereas, prior to limited liability, only the wealthy could afford the risk of personal liability, with the shield of limited liability, persons of modest means were motivated to act in an entrepreneurial manner and participate in the market.[33]

### B. EXCEPTIONS TO LIMITED LIABILITY

Although the incorporation and formation of limited liability companies are designed to isolate liabilities and immunize the designated parties, such immunity is not absolute.[34] An exception to such immunity is "veil piercing," a doctrine which has become one of the most controversial and litigated issues in corporate law.[35]

#### 1. Veil Piercing

Because of the potential for abuse, courts have developed the doctrine of corporate veil piercing, as an exception to limited liability. Whether veil piercing is applicable in the LLC setting was initially unclear. It is, however, now settled that it is.[36] Pursuant to this exception, which is equity-based, the corporate veil will be pierced and the separate legal entity disregarded when the corporation is used as a vehicle to "defeat public convenience, justify wrong, protect fraud or defend crime."[37] The purpose of piercing is to remove the artificial barrier between the corporation and its shareholders in order to reach the assets of the latter and thus thwart fraudulent and illegal schemes that use the corporate personality as a shield for undertaking proscribed activities. Piercing is resorted to as an equitable

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[33] Huss, *supra* note 5, at 103-104.

[34] *See* Stone v. Frederick L. Hobby Associates II, 2001 WL 861822 (Conn. Super Ct. 2001), holding that there was probable cause to find personal liability. The court found that LLC never had assets and the owners used control to wrongfully avoid responsibility for liabilities based partly on defendants' attorney's statement that plaintiffs "go ahead and sue us [the LLC]. There is no money in [the LLC]. Why do you think we set it up as an LLC in the first place?"

[35] Thompson, *supra* note 29, at 1036.

[36] Rapp, *supra* note 4, at 1065 ("Courts were initially forced to determine whether veil piercing would be permitted in the LLC context. That answer, given unanimously by the courts addressing this question, appears to be yes.")

[37] United States v. Milwaukee Refrigerator Transit Co., 142 F. 247, 255 (1905); *see also* Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143, 1154.

remedy, which is applied by the courts depending upon the peculiar facts and circumstances of each case, and in that sense, is highly contextual.[38] The core of this equitable doctrine was restated in *Kaycee Land and Livestock v Flahive*, thus:

> The concept of piercing the corporate veil is a judicially created remedy for situations where corporations have not been operated as separate entities as contemplated by statute and, therefore, are not entitled to be treated as such. The determination of whether the doctrine applies centers on whether there is an element of injustice, fundamental unfairness, or inequity. The concept developed through common law and is absent from the statutes governing corporate organization.[39]

The veil piercing doctrine has been criticized in colorful language as "vague and unprincipled," "like lightning . . . rare, severe, and unprincipled,"[40] "confusing,"[41] "malleable,"[42] "vague, mysterious, unsettled,"[43] "illusory,"[44] "random manner of application,"[45] "quicksilver nature,"[46] and "freakish."[47] But this very vagueness allows courts to adjust and adapt the doctrine when policy objectives change. The equitable nature of the doctrine prevents development of strict rules as to when it should be employed.[48] Any rigid test would be incompatible with the equitable nature of the doctrine.[49]

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[38] *See* Rapp, *supra* note 4, at 1069 ("nor is analyzing the text of judicial opinions in selected LLC veil piercing cases particularly useful since veil piercing is inherently fact specific and what a court says about a particular case has little influence on what courts will do in other cases").

[39] 46 P.3d 323, 326.

[40] Frank Easterbrook & Daniel Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89 (1985). The observation that the equitable remedy of entity veil piecing is "unprincipled" is not surprising, considering that the outcome of piercing cases depends on the "facts and circumstances" of each case and the deciding judge's sense of what constitutes "unjust" outcome under the factual context. Analysis by this means is certain to lead to confusion and unpredictable results, particularly when courts impose vague and unfocused tests that govern the outcome. *See also* John Glode, *Piercing the Corporate Veil in Wyoming – An Update*, 3 WYO. L. REV. 133, 148 (2003).

[41] *Id.* at 89.

[42] In re James Giampierto, 317 B.R. 841, Nov. 23, 2004, at 846 n.6.

[43] Vandervoort, *supra* note 5, at 86.

[44] *Id.* at 81.

[45] *Id.* at 82.

[46] David Posin, *Turning Green: Louisiana's Piercing-the-Corporate-Veil Jurisprudence and its Economic Effects*, 79 TUL. L. REV. 311, 315 (2004).

[47] Rapp, *supra* note 4, at 1080.

[48] Fox, *supra* note 37, at 1155.

[49] *Id.* at n.91, discussing Professor Maurice Wormser's "broad purpose" test to the effect that courts should analyze all circumstances surrounding the case to ensure that the use of the corporate

Although the factors applied by courts in corporate veil piercing cases may be similar, state law, which is not uniform, is determinative in the analysis of each case. As an illustration, under Montana law, courts generally consider two factors in determining whether to disregard the separate identity of a corporation. First, the party seeking to pierce the corporate veil must show that the corporation is the alter ego of the individual. Second, "there must be a showing that the corporate entity was used as a subterfuge to defeat public convenience, justify wrong, or perpetrate fraud."[50]

Under Nevada law, the following non-conclusive factors may indicate the existence of an alter ego relationship: "(1) commingling of funds; (2) undercapitalization; (3) unauthorized diversion of funds; (4) treatment of corporate assets as the individual's own; and (5) failure to observe corporate formalities."[51]

California law recognizes an alter ego relationship, such that a corporation's liabilities may be imposed on an individual, when two conditions are met: "(1) there is such unity of interest and ownership that the individuality, or separateness, of the said person and corporation has ceased, and (2) an adherence to the fiction of the separate existence of the corporation would . . . sanction a fraud or promote injustice."[52]

Under Utah law, two circumstances must exist before a corporate entity can be disregarded: (1) there must be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist; and (2) the observance of the corporate form

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form is in the interest of public policy in line with the theory that the grant of limited liability is a privilege or concession from the state (privilege or concession theory) and Frederick J. Powell's three-prong test: (1) Was there an alter ego relationship, (2) wrongful conduct on the part of the defendant, and (3) unjust loss or injury to the plaintiff? – a formula which adopts the nexus of contracts theory.

[50] Towe Antique Ford Foundation v. Internal Revenue Service, 999 F.2d 1387, 1391 (1993) (The 9th Circuit raised the following issues to determine alter ego status: 1. whether the individual is in a position of control or authority over the entity; 2. whether the individual controls the entity's actions without need to consult others; 3. whether the individual uses the entity to shield himself from personal liability; 4. whether the individual uses the business entity for his or her own financial benefit; 5. whether the individual mingles his own affairs in the affairs of the business entity; 6. whether the individual uses the business entity to assume his own debts, or the debts of another, or whether the individual uses his own funds to pay the business entity's debts.)

[51] LFC Mktg. Group, Inc. v. Loonis, 8 P.3d 846, 847 (2000).

[52] Securities and Exchange Comm. V. Hickey, 322 F.3d 1123, 1128 (9th Cir. 2003) (internal quotation marks and cases cited omitted).

would sanction a fraud, promote injustice, or an inequitable result would follow.[53]

Among the factors usually invoked to pierce the veil are the following: failure to adhere to formalities, use of the corporate form as alter ego or mere instrumentality, under capitalization, and fraud or other wrongful conduct.[54] Some of these factors will be addressed in more detail in the following discussion of jurisprudential trends on LLC veil piercing (see "Trends in LLC Veil Piercing" below).

Most jurisdictions, recognizing that labels like "alter ego" and "injustice" provide little guidance, supplement the fine words by identifying circumstances that support piercing. The list of circumstances varies from state to state, but the key ones include the following:

> disregard of corporate formalities (e.g., failing to have appropriate meetings of directors and shareholders or failing to keep proper records of corporate actions);

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[53] *See* Elham Youabian, *Reverse Piercing of the Corporate Veil: The Implications of Bypassing "Ownership" Interest*, 33 SW. U. L. REV. 573, FN 4 (2004) *citing* Cascade Energy and Metals Corp. v. Banks, 896 F.2d 1557, 1575 (10th Cir. 1990).

[54] A "laundry list" of factors are set out in Amfac Mechanical Supply Co. v. Federer, 645 P. 2d 73 (Wyo. 1982): "(C)ommingling of funds and other assets, failure to segregate funds of the separate entities, and the unauthorized diversion of corporate funds or assets to other than corporate uses; the treatment by an individual of the assets of the corporation as his own; the failure to obtain authority to issue or subscribe to stock; the holding out by an individual that he is personally liable for the debts of the corporation; the failure to maintain minutes or adequate corporate records and the confusion of the records of the separate entities; the identical equitable ownership in the two entities; the identification of the equitable owners thereof with the domination and control of the two entities; identification of the directors and officers of the two entities in the responsible supervision and management; the failure to adequately capitalize a corporation; the absence of corporate assets, and undercapitalization; the use of a corporation as a mere shell, instrumentality or conduit for a single venture or the business of an individual or another corporation; the concealment and misrepresentation of the identity of the responsible ownership, management and financial interest or concealment of personal business activities; the disregard of legal formalities and the failure to maintain arm's length relationships among related entities; the use of the corporate entity to procure labor, services or merchandise for another person or entity; the diversion of assets from a corporation by or to a stockholder or other person or entity, to the detriment of creditors, or the manipulation of assets and liabilities between entities so as to concentrate the assets in one and the liabilities in another; the contracting with another with intent to avoid performance by use of a corporation as a subterfuge of illegal transactions; and the formation and use of a corporation to transfer to it the existing liability of another person or entity." *Id.* at 77-78. (citations omitted)

disregard of corporate governance structure (e.g., allowing a shareholder to make key decisions without consulting directors and officers);

disregard of the corporation's economic separateness (e.g., commingling of corporate and personal funds, commingling of corporate and personal business records, or using the corporation's credit to obtain personal loans);

undercapitalization;

siphoning of funds out of the corporation;

ownership of all or substantially all shares by a single shareholder; and

in the case of a parent and a subsidiary, interlocking directors and officers or using the same name;[55]

**2. Other Exceptions**

Other recognized exceptions to limited liability derive from factors not necessarily linked to the concept of limited liability per se, but are nevertheless considered exceptions because they derogate from the protection accorded by the limited liability principle. These exceptions include liability arising from the corporate shareholder's or LLC member's personal conduct. An LLC member, for instance, can be held liable for a tort committed in the course of LLC business.[56] Individuals acting for LLCs or corporations may also be personally liable for criminal and other

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[55] *See* BISHOP & KLEINBERGER, *supra* note 7, ¶ 6.03(1); In Stinky Love, Inc. v. N. Lee Lacy, 2004 WL 1803273 (Cal. App. 2 Dist.) at 5, the California Court of Appeal identified the following factors in applying the alter ego doctrine: "Among the factors to be considered in applying the doctrine are commingling of funds and other assets; the failure to segregate the funds of the individual and the corporation; unauthorized diversions of corporate funds to non-corporate purposes; the treatment by an individual of corporate assets as his own; disregard of corporate formalities; the ownership of all the stock by a single individual or family; and domination or control of the corporation by the stockholders. An important factor is inadequate capitalization. . . . Failure to maintain arm's-length relationships among related entities is a consideration, as is use of the corporation to procure labor, services or merchandise for another person or entity."

[56] Ventres v. Goodspeed Airport, LLC, 881 A. 2d 937 (Conn. 2005) (finding that a sole member of a limited liability company that owned an airport was personally liable for clear cutting trees in violation of the Inland Wetlands and Water Courses Act where he personally authorized and directed the improper clear cutting of trees by the independent contractor of the limited liability company).

wrongful acts.[57] The fact that his conduct is in connection with, or even in the service of an LLC will not negate liability. This is because the limited liability shield relates only to liability arising from a member's status as such.[58]

The same rationale applies to a personal guarantee.[59] While an LLC member is generally not personally liable for contracts made in representation of the LLC, he will be personally liable if he guarantees an LLC obligation.[60] An LLC member may also be personally liable for his negligence in appointing, supervising or participating in a wrongful activity with a manager, employee, agent or other member of the LLC.[61]

Another exception falls under the so-called collective torts doctrine: tort victims may personally sue individuals identified as central decision-makers in the actionable conduct.[62] It is worth noting again that the basis of liability in this case does not relate to the individual's status as corporate shareholder or LLC member. It is also significant that a member's personal conduct in an LLC could result in a liability not only to the member but to the LLC as well under another common-law created principle called "reverse-piercing."[63]

## IV. TRENDS IN LLC VEIL PIERCING

The language of the relevant LLC statute, corporate law veil piercing principles, and scholarly commentaries appear to shape the emerging LLC veil piercing trends.

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[57] *See* Karin Schwindt, *Limited Liability Companies: Issues in Member Liability*, 44 UCLA L. REV. 1541, 1548 (1997).

[58] *See* BISHOP & KLEINBERGER, *supra* note 7, ¶ 6.04.

[59] *Id.*

[60] *See* Schwindt, *supra* note 57, at 1549.

[61] *See* Bahls, *supra* note 12, at 59-60.

[62] Schwindt, *supra* note 57, at 1548-1549.

[63] Litchfield Asset Mgmt. Corp. v. Howell, 799 A.2d 298, 311-315 (2002); *see generally*, Gregory Crespi, *The Reverse Pierce Doctrine: Applying Appropriate Standards*, 16 J. CORP. L. 33 (1990); *see also* Youabian, *supra* note 53. For a case denying the application of "reverse-piercing," see Cascade, 896 F.2d 1557. ("A reverse piercing claim is when a corporate insider, or someone claiming through him, attempt[s] to pierce the corporate veil from within so that the corporate entity and the individual will be considered one and the same. . . . Utah has addressed that theory only once, and it characterized that theory as little recognized.") Id. at n.17 (citations and internal parentheses and quotations omitted)

## A. STATUTORY DEVELOPMENTS

The various LLC statutes are consistent in providing limited liability, this – and the partnership-like *pass-through tax treatment* – being a basic and fundamental distinguishing characteristic of this business entity form. All LLCs enjoy the protective shield of the entity form.

However, while all the limited liability shields are functionally equivalent, the statutory language varies with respect to the persons covered, the matters shielded against, and the scope of the shield.[64] For example, all the enabling statutes shield members, but some explicitly extend not only to members but also to managers, employees and agents.[65] However, whether the literal language of the statute covers only members or others as well is of no legal consequence because there is no tenet of law that automatically holds an entity's manager, employee, or other agent liable for the debts and obligations of the entity, unlike a member who without the shield would automatically be liable either as a proprietor or as a general partner.[66] Similarly, the legal effect of broad provisions variously specifying the type of liability protected against is the same. Thus, apart from debts, obligations and liabilities, some enabling statutes expressly exclude liability under judgment, decree, or order of a court.[67] Other statutes specify that the shield applies whether the liability arises in tort, contract or otherwise. Such specificity is, however, immaterial, since the shield exists, regardless of the legal theory upon which the liability is based. And the shield must apply to any judgment, decree, order, or other court mandate, whether or not so specified, because the plain language of the law provides a shield from any debt, obligation, or liability of the limited liability entity.[68]

Another difference in language pertains to the apparent intention in some statutes to block any attempt to hold protected members responsible

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[64] For example, the Iowa LLC statute simply provides that "no member or manager of a limited liability company is personally liable for the acts or debts of the limited liability company." In contrast, the Delaware LLC statute is more elaborate: "The debts, obligations and liabilities of a limited company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the limited company; and no member or manager of a limited liability company shall be obligated personally for any such debt, obligation or liability of the limited company solely by reason of being a member or acting as a manager of the limited liability company. " (*Quoted from* BISHOP & KLEINBERGER, *supra* note 7, ¶ 6.01(1).

[65] BISHOP & KLEINBERGER, *supra* note 7, ¶ 6.01(2)(a).

[66] *Id.*

[67] For example the Delaware LLC statute and the Uniform Limited Liability Company Act.

[68] *Id.* ¶ 6.01 (2)(b).

for the entity's debts and obligations, while in other statutes the shield is expressed to apply only to claims made "merely on account of" the party's protected status either as member, manager, or agent of the LLC. A reasonable construction however will result in the same narrow meaning, i.e. that the shield applies to claims made solely because of the protected party's status. To confer absolute immunity to those shielded from claims because of their status as members will make them immune even for their personal conduct.[69]

The Delaware LLC statute is even unique in that it goes beyond providing an overall shield for LLC members. A series of membership interests is permitted to be created and limit claims and obligations pertaining to each series, with "separate rights, powers or duties with respect to specified property or obligations of the limited company or profits and losses associated with specified property or obligations." If provided in the operating agreement, any such series may have a "separate business purpose or investment objective." To the extent that the existence of separate series purports to protect the LLC's other assets and other series' assets from claims against a given series as well as protect the assets of the various series from general claims against the LLC, one could deduce the existence here of an LLC within an LLC, more seriated and independent than the different classes of shares that may be created in corporations.[70] As one author describes it, this permits an LLC "to compartmentalize its operations and create internal shields to protect assets associated with one aspect of the business from claims pertaining to others."[71]

### B. STATUTORY APPROACHES TO VEIL PIERCING

The approach of the various enabling statutes to veil piercing also varies.

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[69] BISHOP & KLEINBERGER, *supra* note 7, ¶ 6.01 (2)(c).
[70] *See* Bendremer, *supra* note 27, at 388.
[71] BISHOP & KLEINBERGER, *supra* note 7, ¶ 6.01(5).

### 1. Explicit Approach

A few expressly recognize the concept. These explicitly import into LLC case law both the corporate doctrine and corporate case law. A typical example is the Minnesota statute:

> The case law that states the conditions and circumstances under which the corporate veil of a corporation may be pierced under Minnesota law also applies to limited liability companies.[72]

The Colorado statute similarly provides:

> In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.[73]

### 2. Implicit Approach

Other statutes merely imply the applicability of corporate veil piercing but make it clear that an LLC member, like a shareholder, can be exposed to personal liability. For example, the Maine statute provides that the exceptions to limited liability applicable to corporate shareholders also apply to members of LLCs. One such exception is, of course, the corporate veil piercing doctrine. The Illinois statute similarly states:

> (A) member of a limited liability company shall be 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.[74]

The Washington statute states: "Members of a limited liability company shall be personally liable for any act, debt, obligation or liability of the limited liability company to the extent that shareholders of a

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[72] *See* Minn. Stat. Ann., § 322B.303 (West 1995).
[73] *See* Colo. Rev. Stat. Ann. § 7-80-107(1) (West Supp. 1997).
[74] *See* 805 Ill. Comp. Stat. Ann., § 180-10-10 (West Supp. 1997).

Washington business corporation could be liable in analogous circumstances."[75]

The Wisconsin statute states: "Nothing in this charter shall preclude a court from ignoring the limited liability company entity under principles of common law of this state that are similar to those applicable to business corporations and shareholders."[76]

### 3. Silent Approach

A third group of state LLC statutes are silent on the issue of veil piercing. These include Ohio, New York, North Carolina, and Kentucky. In this situation, it is argued that the most reasonable view would be that the states intended to defer to the courts to develop a common law doctrine for LLC piercing in the same fashion as the corporate veil piercing standards were developed.[77] There are those who argue, however, that where the statutes are silent courts should use corporate law as a frame of reference for the following reasons: first, in the discourse that has led to the popularization and enactment of the limited liability company concept, the liability shield is always considered a corporate characteristic, and second, in functional terms the corporate liability shield is a far better analogy to the LLC liability shield than any other probable alternative. Since limited partnerships and corporations are the only two plausible analogies, the latter would appear to be the more appropriate choice since, in so far as limited liability and the exceptions to it are concerned, the LLC is obviously more akin to a corporation than to a limited partnership.[78]

### 4. Special Treatment of Specific Factors

The various state LLC statutes recognize the reality that an LLC is member-managed, owned by a few (or even a sole member) members who are actively involved in management, precisely because it is an entity form

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[75] *See* Wash. Rev. Code Ann., § 25.15.060 (Supp. 1997).

[76] *See* Wis. Stat., § 183.0304(2) (West Supp. 1997).

[77] Vandervoort, *supra* note 5, at 66. *See also* Schwindt, *supra* note 57, at 1555 ("One can argue that these states intended to leave it to the courts to develop a common law doctrine of LLC piercing just as they developed a common law doctrine of corporate piercing. The lack of explicit language should not be considered an indication of their desire to make LLC members totally impermeable."). *See also* D.R. Horton Inc. – New Jersey v. Dynastar Development, LLC, 2005 WL 1939778 (N.J. Super. L.).

[78] BISHOP & KLEINBERGER, *supra* note 7, ¶ 6.01(4).

that is invested with the distinctive features of flexible management (like a general partnership), limited liability (like an ordinary corporation) and single tier pass-through tax treatment (like a close corporation and a partnership). The observance of formalities has therefore been expressly renounced as a basis of veil piercing. Thus, the Washington state LLC statute provides that "the failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor tending to establish that the members have personal liability for any act, debt, obligation or liability of the limited liability company."[79] The California statute also states that "where the articles of organization or operating agreement do not expressly require the holding of meetings of members or managers," such formalities shall not be considered for purposes of veil piercing.[80] Finally, the Uniform Limited Liability Company Act (ULLCA) unqualifiedly prescribes:

> The failure of a limited 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 personal liability on the members or managers for liabilities of the company.[81]

These provisions appear to have been in recognition of scholarly suggestions concerning their inappropriateness (even irrelevance in veil piercing situations).

### C. CASE LAW TRENDS

While the limited liability company is spreading like wildfire throughout the United States, it really is of relatively recent vintage compared to the corporation and other business entity forms. It is therefore no surprise that the number of veil piercing cases involving LLCs is still somewhat less than those involving corporations. However, as LLCs catch up with corporations, so will the number of LLC veil piercing cases. Indications gleaned from the enactment of LLC statutes in the various states, the ratio and dicta contained in the decisions of the courts, and

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[79] Wash. Rev. Code Ann., § 25.15.060.
[80] Cal. Corp. Code, § 17101(b).
[81] ULLCA, § 303(b).

commentaries of scholars and academicians yield possible emerging jurisprudential trends impacting the veil piercing doctrine in LLC law.

### 1. Empirical Findings

The general conclusion reached by an empirical study done by Geoffrey Christopher Rapp in late 2005 is that LLC veil piercing does not differ dramatically from the record on corporate veil piercing.[82] LLCs seem slightly less likely to be pierced.[83] Contract cases are more common than tort cases.[84] Piercing is particularly unlikely in LLC cases involving torts,[85] and the rate of piercing does not seem to depend in the LLC context as much on the number of shareholder-owners as it does in the close corporation context.[86] The clear majority of LLC veil piercing cases involved LLCs owned by individuals rather than entities.[87]

With particular respect to tort versus contract veil piercing cases, Easterbrook and Fischel had predicted that veil piercing would be more common in tort cases (where involuntary creditors are unable to negotiate for additional personal guarantees) compared to contract cases (where voluntary creditors negotiate a bargain).[88] Thompson found the opposite.[89] Rapp also found that not only were there more efforts to piercing in contract cases, but plaintiffs in those cases were more successful than tort claimants.[90] This surprising empirical reality may be explained by the fact that in the tort context, sufficient insurance coverage exists to satisfy judgments, making veil piercing unnecessary, or that in tort cases, plaintiffs may be more unsuccessful at arguing that the individual shareholder did something wrongful for which he should be held personally liable, again making veil piercing unlikely.[91] It may also perhaps simply be that in the course of business, LLCs enter into contracts more often than it encounter tort situations, or, even less mysteriously, that contracts accompanied by

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[82] Rapp, *supra* note 4, at 1077.
[83] *Id.*
[84] *Id.*
[85] In an earlier work, Robert Thompson found that with respect to corporate veil piercing cases, courts pierce less often in tort than in contract contexts and pierce more frequently as the number of corporate shareholders decreases. *See* Thompson, *supra* note 29, at 1038.
[86] Rapp, *supra* note 4, at 1077.
[87] *Id.* at 1073.
[88] *See* EASTERBROOK & FISCHEL, *supra* note 32, at 90.
[89] *See* Thompson, *supra* note 29, at 1038.
[90] Rapp, *supra* note 4, at 1073-1074.
[91] *Id.*

wrongful conduct or bad faith tend to offend judges' sense of "honesty and fairness" more than such tortious conduct as permitting a customer to fall on a restaurant's slippery floor.

The factors that appeared, more often, to be most likely to lead to LLC veil piercing are alter ego, undercapitalization, and lack of substantive separation.[92] This confirms Vandervoort's identical view that the emerging trend is for courts to increasingly rely on the alter ego doctrine.[93] When courts found a failure to respect formalities in LLC cases, they pierced only 56% of the time, compared to 66% when courts found such a failure with respect to corporations.[94] These results are substantially similar to Thompson's findings in his study of corporate veil piercing.[95]

### 2. Application of Corporate Veil Piercing Factors

American courts tend to apply the traditional corporate standards for piercing the veil. This would seem to be the predisposition of the courts as cases contain not much analysis over the distinction between corporations and limited liability companies. The courts seem to assume a wholesale application of corporate standards providing little analysis as to how those standards are to be applied.[96]

In *Kaycee Land and Livestock v. Flahive*,[97] the Wyoming Supreme Court, however, acknowledged that "the various factors which would justify piercing an LLC veil would not be identical to the corporate situation for the obvious reason that many of the organizational formalities applicable to corporations do not apply to LLCs." The court declined to spell out the possible facts that would be applied to LLCs but opened the door to future analysis of the piercing factors applicable to LLCs. It is thus reasonable to conclude that having scanty precedents to otherwise rely on, courts tend to analogize the corporate standards to LLCs where the relevant LLC statute does not specify such standards.

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[92] *Id.* at 1076.

[93] Vandervoort, *supra* note 5, at 78-79.

[94] Rapp, *supra* note 4, at 1076.

[95] Thompson, *supra* note 29, at 1063.

[96] Vandervoort, *supra* note 5, at 75 (analyzing fourteen cases in which the court reached the merits of the LLC piercing claim.) For example, in Gallinger v. North Star Hospital Mut. Assur. Ltd., 64 F.3d 422 (8th Circuit 1995), the LLC was referred to as a "corporate entity" that was "incorporated" in Bermuda.

[97] 46 P.3d 323, 328 (2002).

Significantly, while *Kaycee Land* merely gave an intimation of the direction the court may go in the application of corporate veil piercing principles in the LLC setting, in *D.R. Horton, Inc. – New Jersey v. Dynastar Development, LLC*,[98] the Superior Court of New Jersey rendered an extended opinion and analysis of veil piercing as applicable to LLCs and, in express terms, suggested the following rules:

> (1) the traditional approach to veil piercing in the corporate context should not be mechanically applied to LLCs,[99] but must be modified;
>
> (2) the clear and convincing standard of proof ( rather than mere preponderance of evidence) applies to veil piercing claims involving an equitable or legal fraud;[100]
>
> (3) in contract cases, causation is an essential element in determining whether an owner's domination of an entity has been used as an instrument of fraud or injustice or to circumvent the law;[101]
>
> (4) since the New Jersey statute is silent with respect to veil piercing, the statute impliedly endorses the evolution of court-made rules tailored to the LLC's special attributes along the lines recommended by commentators and judicial opinions;[102] and
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> (5) the adherence to corporate formalities, dominion and control by the owner and undercapitalization, as veil piercing factors, should be weighed differently in the LLC context.[103]

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[98] No. MER-L-1808-00, 2005 WL 1939778 (N.J.Super.L) (August 10, 2005).

[99] *Id.* at 33.

[100] *Id.* at 22-24. The court expressly stated that it did not address whether this heightened standard should apply to veil-piercing claims involving tort claimants. In Nevada, the quantum of evidence applicable is preponderance of evidence also described as "plain" and "manifest,". In re James Giampietro, AE Restaurant Associates, LLC v. James Giamperto, 317 B.R. 841, (2004). *See also* Litchfield Asset Mgmt. Corp., 799 A.2d, at 310 ("We conclude that the proper standard applicable to the identity and instrumentality rules is the preponderance of evidence standard.")

[101] D.R. Horton Inc. – New Jersey v. Dynastar Development, LLC, 2005 WL 1939778, at 28-31. (N.J. Super. L.).

[102] *Id.* at 31.

[103] *Id.* at 31-36.

These factors should not play as much prominence or "loom as large" in an LLC veil piercing claim as in the case of a corporate veil piercing.

*a. Alter Ego*

Even prior to *Horton – New* Jersey, courts had become increasingly reliant on the alter ego or instrumentality doctrine.[104] Starting with the early LLC piercing cases, this trend has continued and can be found in recent LLC piercing cases. Thus, a two-pronged New York standard formulated in *Nettech Solutions LLC v. Zippark.com*[105] states in effect that:

> the corporate veil may be pierced if a corporation is essentially an alter ego of a family or individual. In order to pierce the corporate veil on a claim for breach of contract, the following conditions must be shown: (1) the complete domination of the corporation with respect to the transaction at issue, and (2) that such domination was used to commit a fraud or wrong against the aggrieved party.[106]

In *Nettech Solutions*, it was shown that the LLC must exercise complete control over the subject LLC, the LLC had no employees, the LLC was involved in no business other than that derived from the arrangement with the plaintiff, and all of the plaintiff's dealings with the LLC were conducted through the LLC member.[107]

A Colorado Court of Appeals also applied the alter ego factor in *Great Neck Plaza v. Le Peep Restaurants, LLC.*[108] The court stated that "the corporate entity may be disregarded, and (the) corporate veil may be pierced, if not doing so would defeat public convenience, justify wrong, or protect fraud. Specifically, the veil may be pierced where the subsidiary is merely an alter ego of the principal."[109]

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[104] *See* Vandervoort, *supra* note 5, at 76.
[105] 2001 WL 1111966 (2001).
[106] *Id.* at 11.
[107] *Id.*
[108] 37 P.3d 485 (2001).
[109] *Id.* at 490.

In *Bonner v. Brunson*,[110] clearly deferring to corporate common law, the court held:

> Just as the so-called 'corporate veil' protects an individual shareholder of a corporation from personal liability for the debts of the separate corporate entity (so long as the corporate forms are maintained), so is a member of a limited liability company (LLC) "veiled" from personal liability for the debts of the separately maintained LLC entity. In order to pierce this veil and hold Brunson personally liable for the alleged debt of the LLC, there must be evidence *that he abused the forms by which the LLC was maintained as a separate legal entity apart from his personal business.* 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.*[111] (citations omitted; emphasis supplied)

Finally, in Connecticut, *Litchfield Asset Mgmt Corp v. Howell*[112] parsed the alter ego standard for piercing the corporate veil into the instrumentality rule and the identity rule.

The "instrumentality rule" is three-pronged: (1) control, not mere majority or complete stock control, but complete domination, not only of finances but of policy and business practice with respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; (2) such control must have been used by the defendant to commit fraud or wrong, to perpetuate the violation of a statutory or other positive legal duty or a dishonest or unjust act in contravention of the plaintiff's legal rights; and (3) such control and breach of duty must proximately cause the injury or unjust loss to plaintiff.

The "identity rule", on the other hand, is applicable to situations where "two corporations are, in reality, controlled as one entity because of common owners, officers, directors, members or shareholders, and because of a lack of observance of corporate or company formalities between the

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[110] 585 S.E. 2d 917 (2003).
[111] *Id.* at 918.
[112] 799 A.2d 298, 312-315 (2002).

two entities."[113] Professor Phillip Blumberg calls these two tests variants of the same test.[114]

It is surmised that the emerging trend to rely increasingly on the alter ego doctrine is most likely the result of the decreased utility of the corporate formalities factor and the complexity involved in applying the undercapitalization factor.[115]

From the foregoing, it becomes clear that whether one denominates it as "alter ego standard," "instrumentality rule" or "identity rule," the test requires the element of control and domination by one party of the subject legal entity or the lack of separation between them in such areas as business purpose, assets, funds, personnel, or business activities. [116] In addition, to justify lifting the veil, some inequity or injustice must result.[117]

As with other traditional piercing factors (e.g. failure to observe formalities, lack of separateness and undercapitalization), the court's willingness to pierce LLCs based on the alter ego, instrumentality or identity rules as applied to corporations presents a dilemma. These rules owe their progeny to corporate law practice which, when transported to the LLC

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[113] Vandervoort, *supra* note 5, at 78; *see also* Stone v. Frederick L. Hobby Associates II, 2001 WL 861822 (Conn. Super Ct. 2001) ("Piercing the corporate veil, or alternately the alter ego theory, may be proven through the instrumentality rule or the identity rule.")

[114] *See* PHILLIP BLUMBERG, THE LAW OF CORPORATE GROUPS: SUBSTANTIVE LAW 111 (1996). First, the instrumentality doctrine is a three-prong test that includes: (1) excessive ownership and control; (2) inequitable conduct; and (3) a causal relationship to the claimant's loss. See Id. at 112-114. Second, the alter-ego doctrine is a two-part test where the corporate veil is pierced when: (1) such unity of ownership exists that two affiliated organizations are no longer separate entities such that the subsidiary is the parent's alter ego; and (2) where recognition of the two corporations as separate entities would sanction fraud and inequity. See Id. at 118, § 6.03. Third, the identity doctrine is where there is such unity of interest and ownership that adherence to the legal fiction of a separate entity would defeat equity and justice. See Id. at 122-123, § 6.04.

[115] Vandervoort, *supra* note 5, at 78-79. *See also supra* notes 73-75 and accompanying text discussing state LLC statutes renouncing observance of formalities as a basis for veil piercing.

[116] *See e.g.*, Litchfield Asset Mgmt Corp, 799 A.2d at 313 ("Courts, in assessing whether an entity is dominated or controlled, have looked for the presence of a number of factors. Those include: "(1) the absence of corporate formalities; (2) inadequate capitalization; (3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes; (4) overlapping ownership, officers, directors, personnel; (5) common office space, address, phones; (6) the amount of business discretion by the allegedly dominated corporation; (7) whether the corporations dealt with each other at arm's length; (8) whether the corporations are treated as independent profit centers; (9) payment or guarantee of debts of the dominated corporation; and (10) whether the corporation in question had property that was used by other of the corporations as if it were its own.") (Internal quotation marks and citations omitted)

[117] *See supra* note 128 and accompanying text.

setting, clash with the underlying legislative policies embedded in the distinctive and specially designed traits of the LLC. The state LLC statutes, for instance, expressly authorize flexible and informal management structures with concentrations of power and control in one or just two members. Small business owners, for whom the LLC is intended, are attracted to the absence of corporate formalities and the less cumbersome and simpler formal corporate management structures, and the management flexibility offered by the LLC statutes is viewed as a real advantage. Indeed, LLCs are used largely in small business settings, and are most "attractive for small businesses because of the informality and flexibility which they offer."[118]

Yet, it may be these very same distinctive LLC features that could be construed by the courts to find dominance and control. In *Stone v. Frederick Hobby Assoc. II*, the court stated that "the first element of complete control is certainly present, as would be the case for most limited liability companies having only two members who are also the only two owners and managers."[119] The court's scrutiny of "control" comes in direct conflict with the underlying legislative policy of the LLC (to provide flexibility of management structure). Thus, it is ironic that the very incentives that attract investors to the LLC expose them to the risk of losing their statutory limited liability status.[120]

To reiterate, reliance on dominance and control of the LLC form also conflicts with the underlying policy of flexibility within the LLC statute. LLCs are, more often than not, managed by the LLC members themselves. In addition, generally speaking, members are normally authorized agents and/or managers of LLCs for the purpose of conducting its affairs. As such, it could be argued that the alter ego factor is usually satisfied for LLCs. As one commentator noted, given the statutory authorization of flexible LLC management structures, nomination of LLC management by members of the LLC, absent other equitable issues, would appear to be an "inappropriate" factor for the courts to use to pierce the

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[118] Friedman, *supra* note 22, at 54, *cited in* Rapp, *supra* note 4, at 1067.

[119] Stone, 2001 WL 861822 at 10.

[120] Matheson & Eby, *supra* note 2, at 175 ("Indeed, it is strange that statutory protections for owners have evolved into an essential instrument used for stripping them of their statutory limited liability.")

veil to the detriment of the interest holders.[121] Thus, application of the alter ego factor to LLCs will often lead to "illogical" results.[122]

*b. Observance of Formalities*

Recognizing failure to observe procedures and formalities, which in corporate veil piercing law has been cited as probative of the existence of domination and control and of lack of separation, as a factor in LLC veil piercing, likewise clashes with the legislative LLC policy. In *Hollowell v. Orleans Regional Hospital,* the court cautioned that while corporate piercing doctrine applies to LLCs, strict adherence to "formalities" may not be appropriate.[123] Giving less weight and importance to the formalities standard for veil piercing appears to be the present trend even in corporate law.[124] Thus, the *Model Statutory Close Corporation Supplement (to RMBCA), Section 25*, provides:

> The failure of a statutory close corporation to observe the usual corporate formalities or requirements relating to the exercise of its corporate powers or management of its business and affairs is not a ground for imposing personal liability on the shareholders for liabilities of the corporation.[125]

In a marginal case of veil piercing, a court may view the failure to hold meetings or observe such other formality as the "straw that broke the camel's back" and find veil piercing. But the greater informality permitted by LLC statutes arguably should, in an LLC case, lead to a different result. Fortunately, many LLC statutes deal with this type of case by explicitly providing that an LLC's failure to observe formalities is not a ground for veil piercing.[126] Added to the fact that the failure to observe formalities is rarely a ground for veil piercing but is merely one of many factors to be

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[121] Vandervoot, *supra* note 5, at 70.

[122] D.R. Horton Inc. – New Jersey v. Dynastar Development, LLC, 2005 WL 1939778, at 35 (N.J. Super. L.) *citing* J. Vandervoort, *supra* note 5. *See also* Cohen, *supra* note 15, at 457 (stating that dominance of the entity by owners has no application to LLCs); Fox, *supra* note 37, at 1173-74 (concluding that "domination of an LLC by its members should not be given significant weight in LLC veil-piercing cases").

[123] No. Civ. A. 95-4029, 1998 WL 283298 at 9-10, affirmed 217 F3d 379 (5th Circuit 2000).

[124] *See* Giampietro v. AE Restaurant Associates, LLC, 317, B.R. 841 (D. Nev. 2004) (Disregard for corporate formalities did not justify veil piercing because plaintiff knew and "did not rely upon, or even care about, the lack of formality.")

[125] § 33-18-250 of the South Carolina Statutory Close Corporation Supplement contains an identical provision, http://www.scstatehouse.net/CODE/t33c018.htm (last visited 05/02/07).

[126] California, Colorado, Delaware, Maine, Tennessee, Washington LLC statutes and ULLCA.

taken into account, the trend now is clearly to put reduced emphasis on the observance of formalities as a factor in LLC veil piercing cases.[127] Even so, however, because LLCs are statutorily required to keep adequate books and records, maintain a registered agent for service of process, and properly designate the business as an LLC, these formalities should be kept.[128] Except in the states where the statute expressly excludes them as a factor, failure to do so could continue to be a consideration in assessing the existence of an alter ego situation.[129] Thus:

> In truth, the kinds of behaviors veil piercing might induce on the part of LLC operators are not all that burdensome. One commentator advised LLC owners to ensure that (1) one member does not operate the company without consultation from other members; (2) the business is held out as a separate legal entity; (3) that members do not usurp the corporate decisions of the manager, when the LLC elects to have the LLC manager managed; and (4) members don't commingle personal funds or property with that of the LLC or hoard company assets for personal use. All of these suggestions are really just good business practice. While avoiding commingling funds, for example, might be somewhat inconvenient, it also makes it more likely that a small business will be able to monitor accurately its cash flows, something that is profit-enhancing rather than wasteful. Similarly, ensuring that an LLC is managed by its manager, or by participation of all, rather than a single member-owner, is really just good corporate governance.[130]

*c. Undercapitalization*

Apart from alter ego and failure to observe formalities, Rapp's empirical study disclosed that undercapitalization was a significant factor in LLC veil piercing.[131] This is consistent with Thompson's corporate veil

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[127] *See* Cohen, *supra* note 15, at 457 ("[T]o allow piercing for disregarding LLC formalities . . . will make the promise of limited liability for LLCs empty by definition.")

[128] Doing so could help avoid LLC veil piercing claims. *See, e.g.*, KLM Indus. v. Tylutki, 815 A.2d 688, 693 (Conn. App. Ct. 2003). The KLM court reversed the lower court's finding that the veil should be pierced and noted that the defendant entity "maintained its returned checks and statements, filed and maintained corporate tax returns, and filed its biannual reports."

[129] *See* Bahls, *supra* note 12, at 63-36.

[130] Rapp, *supra* note 4, at 1083 (footnote and citations omitted).

[131] *Id.* at 1076-1077. Table Seven of Rapp's study indicates the following factors as contributing most numerous times in the LLC veil piercing cases surveyed: (1) alter ego, (2) domination and control, (3) formalities, (4) undercapitalization, and (5) lack of substantive separation.

piercing findings and the likelihood is that the courts will continue to analogize corporate law doctrines in this area to the LLC setting. As Debra Cohen-Whelan suggests, undercapitalization is the only factor that courts could apply to LLCs to protect all company creditors (voluntary and involuntary), and, although it has not been a significant factor in corporate veil piercing, may become increasingly a factor that courts will consider when determining whether an LLC's veil should be pierced.[132]

Undercapitalization is a factor that should be weighed carefully in the LLC context, particularly involving a start-up. In *Advanced Telephone Systems, Inc. v. Com-Net Professional Mobile Radio, LLC*,[133] the court found no injustice in maintaining limited liability where the plaintiff knew it was dealing with a limited liability company that initially had no assets, but would only acquire those assets when agreement is reached with a third party and financing is obtained. The agreement did not materialize resulting in the LLC being undercapitalized. Commentators agree that a limited liability company's undercapitalization, albeit a highly relevant factor, should be considered in light of the surrounding circumstances.[134]

In sum, the veil-piercing formula for limited liability companies should be molded to account for that business form's special attributes.[135]

## V. CONCLUSION

The indeterminacy that has plagued the doctrine of veil piercing for over a century since even before Cardozo's 1926 decision will continue into the indefinite future, as will the academic controversy with its sometimes vehement arguments.[136] It is comforting to note, however, that despite the hot debate on the issue and the proclaimed indeterminacy, inconsistency

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[132] Debra Cohen-Whelan, ***Individual Responsibility in the Wake of Limited Liability***, 32 U.S.F. L. REV. 335, 357-358 (1998); *but see* Vandervoort, *supra* note 5, at 80 (". . . it is clear that courts have become increasingly dependent on the alter ego doctrine in LLC piercing cases.")

[133] 846 A.2d 1264 (2004).

[134] *See* Cohen, *supra* note 15, at 491 (suggesting that courts inquire whether the entity was formed with explicit intent of engaging in risky transactions and being undercapitalized given the risks, and then concluding that such facts would be evidence of unconscionable behavior toward involuntary creditors, but not toward voluntary creditors "unless the LLC's purpose was obscured or misrepresented.").

[135] D.R. Horton Inc. – New Jersey v. Dynastar Development, LLC, 2005 WL 1939778, at 36 (N.J. Super. L.).

[136] Rapp, *supra* note 4, at 1066 ("In a scathing attack, Bainbridge argues that veil piercing has no place in the developing case law of the LLC.")

and unpredictability that scholars and academicians find in the analysis and application of this long-running doctrine in the court opinions, the courts by and large appear to reach the correct and just results.

The perceived uncertainties associated with the veil piercing principle as applied to the LLC context proceeds from the general trend that as noted in *Hollowell v. Orleans Regional Hospital*, the LLC veil may be pierced "in the same manner as the corporate veil." The opaqueness of the corporate veil piercing standards finds itself carried over to the LLC context, albeit concededly somewhat clarified by specific provisions of applicable LLC statutes.

Indeed, most LLC cases involving veil piercing purport to apply corporate standards. Some LLC statutes expressly or implicitly require the application of corporate standards. Because corporate standards remain murky to this day, it is foreseen that calls for abolition, some reform or at least preservation of this safety valve against abuse of the LLC limited liability privilege will continue, as courts import the corporate veil piercing doctrine into LLC law.

Until state legislatures adopt legislation that specifically addresses when veil piecing is or is not appropriate, the courts will tend to exercise their discretion in determining what is inequitable, unjust or unfair, subconsciously employing varying standards of "unconscionability and good faith" in applying the equitable remedy of veil piercing. As Cohen points out:

> The courts and commentators have struggled with the doctrine of unconscionability and good faith, recognizing on the one hand its necessity as a 'safety valve to ensure a minimum level of fairness in contracting.' On the other hand, courts also recognize the danger of making the law unpredictable and giving themselves too much discretion to develop standards that cannot be defined clearly or consistently. Thus, any court that wishes to embark on the path of piercing the veil via unconscionability doctrine runs the risk of making an already vague doctrine even more vague and causing a tremendous

uncertainty regarding the strength of an LLC's protection of limited liability.[137]

Yet, paradoxically, any attempt to legislatively clarify the veil-piercing doctrine appears destined for failure. Because this doctrine is inherently a "gap-filler," it lets the courts deal with the many cases that statutory rules effectively cannot resolve;[138] hence, its perimeter may not be definitively circumscribed.

Veil piercing is therefore predicted to remain a conundrum for as long as it is a remedy founded in equity. The tests apposite to its application will, in the words of Justice Cardozo, remain but broad judicial "tests of honesty and justice."[139]

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[137] Cohen, *supra* note 15, at 488-489.

[138] Larry Ribstein, *The Emergence of the Limited Liability Company*, 55 BUS. L. 1, 9 (1995).

[139] Berkey v. Third Ave. Ry. Co., 155, N.E. 58, 94-95 (N.Y. 1926). (The full passage in Berkey reads: "The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often enslaving it. We say at times that the corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterized as an 'alias or a dummy.' All this is well enough if the picturesqueness of the epithets does not lead us to forget that the essential term to be defined is the act of operation. Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent. Where control is less than this, we are remitted to the tests of honesty and justice. . . . The logical consistency of a juridical conception will indeed be sacrificed at times, when the sacrifice is essential to the end that some accepted public policy may be defended or upheld. This is so, for illustration, though agency in any proper sense is lacking, where the attempted separation between parent and subsidiary will work a fraud upon the law. . . . At such times unity is ascribed to parts which, at least for many purposes, retain an independent life, for the reason that only thus can we overcome a perversion of the privilege to do business in a corporate form.")