TOO MANY COOKS SPOIL THE CAKE, AND TOO MANY STATUTES SPOIL THE LLC: A PLEA FOR UNIFORMITY

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There is widespread agreement that closely held enterprises play a critical role in this country. Even if some economists are questioning whether all closely-held businesses offer the same long term benefits for the economy in terms of job-production or innovation, the reality that so many American businesses are in fact closely held means that such enterprises are significant to a very large number of individuals. In the past thirty years, we have seen dramatic and unparalleled growth in the range of operational structures available to such businesses. Regrettably, in the rush to try and

benefits of uniform, predictable and well-understood operational structures. We continue to modify, adapt, and innovate so rapidly that the ideal business

universally based on partnership statutes: the limited liability partnership or LLP[4] (which is based on the general partnership) and the limited liability limited partnership or LLLP[5] (which is based on the limited partnership). The other addition to the menu of enterprise options is the limited liability company (LLC),[6] a version of which is now available in every American

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Maryland, Missouri, Montana, Nevada, Pennsylvania, South Carolina, Texas, Vermont, Wisconsin, and Wyoming, along with the District of Columbia as having such statutes, and also noting that

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an operational standpoint.

have not yet "gone public" in the sense of registering any of their equity interests with the Securities Exchange Commission may still be owned by such a widely diverse group of investors that they are not "closely held" under this definition. For example, in the relatively recent past, a company was only required to be publicly registered when it had at least 500 shareholders.[17] The JOBS Act of 2012 increased the number of shareholders that an enterprise could have before it is required to register as a public company to the lesser of 2000 total or 500 "unaccredited" investors.[18] Thus, it is possible to have a company with a very large number of widely dispersed, passive investors that is still not a registered "public" company.

In addition to ignoring single-owner enterprises (on the grounds that they are unlikely to run into serious problems with LLC statutes, even as written), this article presumes that either existing default and gap-filler rules in the

Helms v. Duckworth, 249 F.2d 482, 486 (1957). The court then cited other authorities that suggest focusing on the number of shareholders and market for shares. Galler v. Galler, 203 N.E.2d 577 (1965); F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.02 (3d ed. 2003). Modern jurisprudence has embraced the *Donahue* definition, and it is general accepted that a corporation with a limited number of shareholders, no ready market for shares, and typically some substantial participation in management by shareholders, will have the special needs general

corporate statutes work well for the publicly traded company, or at least that such enterprises are generally run or advised by professionals with sufficient resources and sophistication so that they understand and can operate well within those rules. Similar assumptions are made for companies that have large numbers of sophisticated, widely dispersed passive investors even if the company is not technically publicly held because it has never had a public offering and has no securities registered under the federal securities laws. A business characterized by widely dispersed, passive ownership and an

zero employee firms which represented roughly 78% of all firms," although many of these were second businesses or independent consultants.[28] The majority of these "small" businesses were and presumably still are owned by persons who do not aspire to have their businesses become large or publicly traded.[29] Instead, such firms appear to be

Americans and the American dream,[37] sometimes despite the lack of pecuniary or economic benefit.[38]

Regardless of whether one believes small, closely held enterprises are valuable for the boost they can provide to the economy, or because they promote happiness among millions of business owners who do not seem to want to be part of "big business," it is clear that such enterprises are an essential component of our current economic landscape. It therefore makes sense not to ignore them when considering statutory options for business structures, even if one wishes to criticize outright subsidies.[39]

B. Historical Organizational Alternatives for Multi-Owner Businesses

The current legislative landscape offers a large and seemingly ever-growing list of organizational alternatives available to businesses, many of them still structured with the requirements of outdated tax regulations in mind. To understand how

in 1977,[40] all states authorized multi-owner businesses to organize as general partnerships, limited partnerships, or corporations. While there was some variation among the states with regard to how each of these forms of enterprise were to operate, there was also a great deal of similarity in the way these businesses were set up.

The predominate statutory model for the general partnership was the Uniform Partnership Act (UPA);[41] limited partnerships in most states were governed by the Revised Uniform Limited Partnership Act (RULPA);[42] and, although there was somewhat wider divergence among the states when it came to corporations, the prevalent model for corporate statutes was the Model Business Corporation Act (MBCA).[43] Even in jurisdictions possessing corporate statutes not directly modeled on the MBCA, th

the business was to be run.[53] Finally, if any partner died, became incapacitated, or withdrew from the partnership for any reason, that triggered at least a technical dissolution of the partnership,[54] even if the withdrawal was in violation of an agreement between the partners.[55]

there were specific meeting and record-keeping requirements for corporations in order to make sure that shareholders had at least some minimal right to information even if they did not serve on the board.[68] The death or incapacity of one or more shareholders had no effect on the continuing existence of the corporation,[69] which for all intents and purposes was a legal entity independent of the persons who technically "owned" it. The residual power of the shareholders as owners was essentially their power to replace directors, rather than to participate directly in management of the business.[70] On the other hand, if the shares were sold, under universally applicable default rules the purchaser became the shareholder with no need for additional approval by either the directors or other shareholders. With limited exceptions, these rules and the built-in formality, including the necessity for annual "meetings" and votes to re-elect directors each year, applied even if the corporation was owned by a single individual or very small group of persons. Many of these rules were mandatory.

Although there were three options for multi-owner business organizations under state law, federal tax regulations essentially required that all of these forms of enterprise be classified either as tax partnerships or associations taxable as corporations. The way in which this classification worked was somewhat convoluted.

C. *The Corporate Resemblance Test*

Although businesses are organized under the laws of individual states, the tax status of those enterprises, at least for purposes of federal income taxes, depends on federal law.[71] In general terms, prior to the last two decades, this meant that the question of how American businesses were classified for tax purposes depended on the corporate resemblance test, which required that companies be evaluated to determine whether or not they

68. MODEL BUS. CORP. ACT §§ 7.01-7.08, 8.20-8.25, 16.01-16.06, 16.2-16.21 (AM. BAR A

possessed certain, defined "corporate" characteristics.[72] There were six characteristics utilized in this approach: the presence of associates; a business purpose; continuity of life for the enterprise; centralization of management; limited liability; and free transferability of interests.[73] The presence of associates was required in order to distinguish sole proprietorships (which are disregarded as not involving a separate entity for tax purposes),[74] and the requirement of a business purpose helped ru

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D. The LLC and LLP

The very first statute authorizing domestic LLCs was enacted in Wyoming in 1977, as special interest legislation designed to assist a particular mineral concern that explicitly wanted to form a business entity

Perhaps not surprisingly, once the floodgates were opened, some enterprising soul had to ask the question of why it was impossible to form a partnership with limited liability for the partners, when the members in an LLC could be given the benefits of partnership income tax status. The original driving force behind LLP legislation was in fact the perceived unfairness in imposing personal liability on partners in professional

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took effect on January 1, 1997.[93] Although the regulations are widely known as the "check-the-box" rules,[94] it would be more appropriate to call them the "don't-check-the-box" regulations because they provide that most unincorporated business forms will be taxed as partnerships unless a specific election is made to have them taxed as corporations. Since the preferable result for most small, start-up businesses is to achieve partnership tax status, there is really no need to "check-the-box."

Under the tax regime now in effect, a determination must be made as to whether there is a separate entity for federal tax purposes. This is a matter of federal tax law.[95] If there is no separate entity for federal tax purposes, the check-the-box regulations will not apply. If there is a separate entity, the second determination is whether the entity is a trust or other business entity.[96] If the business entity is not a trust, the next question is whether the business should be taxed as a corporation or a partnership.

The answer to this question first requires a determination of whether the entity has to be automatically classified as a corporation for federal tax purposes.[97] An entity will be automatically classified as a corporation for federal tax purposes if it is any of the following: (i) an entity denominated a corporation under applicable state law; (ii) a joint-stock company; (iii) an insurance company; (iv) a certain type of banking association; (v) a State-owned organization; (vi) any form of business association taxable as a corporation under special provisions of the Internal Revenue Code;[98] or (vii) one of a list of specified organizations formed under the laws of certain

93. Treas. Reg. §§ 301.7701-1 to -3 (1996). In addition to the actual regulations, there are conforming changes to various sections in the Income Tax Regulations and the Procedure and Administration Regulations.

94. *See* Maimonides

foreign jurisdictions or U.S. possessions, territories or commonwealths.[99] If the entity is not automatically classified as a corporation, the final determination is whether it has two or more members. If it does, the entity will be classified as a partnership unless a specific election to seek corporate tax status has been made.[100] If it does not, the entity will be disregarded as an entity separate from its owner, again unless a specific election to be taxed as a corporation has been made.[101] These rules essentially mean that most privately held general partnerships, LLPs, limited partnerships, LLLPs and multi-owner LLCs organized under state law will be taxed as partnerships under the default rules, although these businesses can elect corporate tax status, while all incorporated enterprises must be taxed as corporations with no possibility of electing partnership tax status.

While much of the experimentation with business forms and options in recent years has been tax-driven, one of the newer options was explicitly designed to address the perceived need to offer an organizational structure that better suited the needs of closely held businesses that were satisfied with (or perhaps resigned to) being taxed as a corporation. This option was the statutory close corporation.

III. THE FAILURE OF THE STATUTORY CLOSE CORPORATION

As mentioned at the outset of this article, a few states have experimented with a statutory option specifically designed to address the needs of closely held corporations.[102] These states enacted special corporate statutes designed to help the corporate form work better for smaller businesses instead of having a single statute more likely to be suited to large, publicly held enterprises.[103] Unfortunately, these efforts appears to have failed, at least based on the fact that so few businesses have acted to accept the supposed

99. Treas. Reg. § 301.7701-2(b) (1967).

100. Treas. Reg. § 301.7701-3(b)(1)(i) (1967).

101. Treas. Reg. § 301.7701-3(b)(1)(ii) (1967). Note that this change addresses what was previously an open issue. Prior to the "check-the-box" regulations, the tax status of a single member LLC was uncertain. The check-the-box regulations now explain how such entities are to be treated for tax purposes. Such ent c10 0 1 24407.94 Tm[( )]P62.07 267.94 37.910 0(a)-12(t)0(n)-13(o)1n5[(p)-13(r)42(c)-162c[-13(td)-9(e)15( )-6(t

benefits of this special legislation.[104] Since one of the primary theories advanced in this article is that we should learn from this failure in deciding how

corporations, so that failure to elect statutory close corporation status where offered does not generally mean that the corporation is not a "close corporation."[110]

There are sixteen states with specific statutory close corporation codes, but there are also a number of other states that include isolated provisions in their general corporate law granting certain corporations the right to adopt special policies governing how their company is to be operated.[111] One of the most common of these options is the right for qualifying corporations to have unanimous shareholder agreements that vary the "usual" manner of operating the enterprise.[112] Although some of these statutes apply to all companies that are not publicly traded, and therefore might not be seen as provisions specifically geared towards "close corporations," the requirement of unanimity in such agreements tends to limit the usefulness of such provisions to corporations with a very sm220003>184ther1 0 0 76.96 A>

It is obviously impossible to know how many smaller corporations have unanimous shareholder agreements, because those are not generally public documents, but the reality is that any time a shareholder agreement has to be negotiated and drafted, lawyers' fees are likely to go up,[115] or unsophisticated entrepreneurs are likely to seek to minimize expense by "doing it themselves" and avoiding legal assistance all together. It is therefore not implausible to assume ile to

but the available data suggests that only about 5% of such businesses elect to be subject to the rules that were supposedly designed to favor closely held enterprises.[120] This pervasive underutilization of the statutory close

attending meetings in person. Even the requirement that there be annual elections of directors, with formal documentation of the actions taken at all meetings of either the shareholders or the directors, is more elaborate and structured than would be ideal for most small businesses.[125] These are precisely the kinds of issues that the close corporation statutes were designed to address.

Why, then, are the close corporation statutes so underutilized? A large number of theories have been advanced to explain this phenomenon. One school of thought is stat(o)

are simply not familiar with the benefits that might be available under the close corporation provisions.[130]

there are more firms organized in a particular way, this increases the likelihood that ambiguous provisions will be clarified through litigation by other parties.[137] Similarly, if more investors are familiar with the structure, this can decrease their informational costs associated with learning about the structure.[138] These network and familiarity effects of popular statutory frameworks are now well accepted,[139] but simply do not apply when a new option is only rarely adopted.

One thing that has compounded this problem in the context of close corporations is the wide variation that exists in state close corporation acts.[140] While there is substantial agreement in the academic literature about some of the ways in which general corporation laws work poorly for closely held businesses, this does not mean that state legislatures have reacted in the same way to these concerns. For example, it appears to be relatively obvious and widely accepted that traditional corporate statutes impose too many formalities for many smaller businesses, ranging from the requirement that a corporation must adopt bylaws, to the mandates that it must hold annual shareholder meetings and must have meetings of directors, to the obligation to document actions taken by the board in writing or other form capable of being transcribed. Similarly, it seems inappropriate to have a default rule that mandates the management by directors who must be regularly re-elected, and who are then supposed to act as members of a board, even if they are also the

codes and a variety of documents drafted under those codes.[145] It also meant that a great many business that would be eligible for the new alternatives were already set up and operating under traditional corporate rules, meaning that future precedents would also be more likely to address traditional language.[146] In addition, not only were there many more judicial explanations and clarifications in place than might be anticipated under the new regime, but businesses and business owners themselves had amassed a high degree of familiarity and experience with the traditional corporation.[147] Parallel to this was the fact that lawyers had become increasingly familiar with

despite being explicitly drafted with the goal of better suiting the needs of smaller enterprises, have not been terribly successful. In fact, such statutes appear to be a failed experiment in legislative efforts to offer entrepreneurs attractive and efficient alternatives for the structure and operation of closely held businesses.[150] This brings us to the LLC, and the question of whether it is the successful alternative that it could and should be, and, if not, what can be done to remedy any deficiencies in our LLC statutes.

IV. THE LLC AND CURRENT DEFAULT RULES

Every American jurisdiction now authorizes the formation of the LLC. Unfortunately, there is probably more variation in the provisions of state LLC acts than for any other kind of widely available form of business, even the statutory close corporation. One of the reasons for this is that by the time the Uniform Law Commission first promulgated a Uniform LLC Act in 1994, "nearly every state had adopted an LLC statute, and those statutes varied considerably in both form and substance."[151] Since that time, many state LLC

(2013).[154] This leaves most states with non-uniform legislation governing this form of business.[155]

Aside from differences in terminology and organization, there are substantial substantive d

differ.[158] For purposes of the federal income tax code at least, all LLCs with two or more members are presumed to be taxed as partnerships.[159]

Starting with more basic rules, all

regardless of the state of formation.[163] LLCs are universally allowed to be organized for "business" purposes,[164] although some states go further and allow LLCS to be organized for any "lawful" purpose.

State LLC statutes are generally very flexible, offering organizers substantial freedom of contract in choosing to abandon most of the default and gap-filler rules that appear in LLC statutes.[165] In general, when organizers do wish to change from the default rules, they do so through an operating agreement or similar document,[166] which takes the place of a partnership agreement in the case of partnerships or bylaws in the case of corporations. Absent contrary provisions in such an agreement (or the articles), contributions to an LLC may be made through cash, property, services performed to be performed, or promises to make payments of cash

163. *Checklist, supra* note 159, at 1259 n.10 ("Every LLC act requires the designation by the company of a registered agent.").

164. UNIF. LTD. LIAB. CO. ACT § 108, 6B U.L.A. 88 (2008 & sup. 2016) (noting that some statutes, including ULLCA (2013), are broader than this, permitting any "lawful" purpose, but concluding that all states authorize all business purposes). Outside the context of the LLC acts, however, other state requirements may limit the use of the LLC in certain contexts.

official,[175] some upon filing,[176] some upon filing or acceptance if there is at least substantial compliance with the statute,[177] and some specify that the LLC does not technically come into existence until there is at least one member,[178] or until the articles become "effective."[179]

Some states also require that the members of an LLC have an operating agreement, which may have to be written,[180] although it is not clear whether failure to do so affects the validity of the LLC's existence.[181] If there is an operating agreement, it is not always clear whether an LLC that is not a party to the operating agreement is bound by its terms, although some statutes specify that it is.[182]

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175. *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 4A-202(b) (LexisNexis 2014) ("A limited liability company is formed at the time when the Department accepts the articles of organization for record or at a later time specified in the articles, if in either case there has been substantial compliance with this title.").

176. *E.g.*, 15 PA. CONS. STAT. ANN. § 8914(b) (West 2008 & Supp. 2015) ("A limited liability company is organized upon the filing of the certificate of organization in the department or at any later effective time specified in the certificate of organization.").

177. For example, the Maryland statutes speaks in terms of "accepting" the documents, but also adds the requirement that the document be in "substantial compliance" with the LLC statute. MD. CODE ANN., CORPS. & ASS'NS § 4A-202(b) (LexisNexis 2014).

178. UNIF. LTD. LIAB. CO. ACT (amended 2013) § 201(d), 6B U.L.A. 102 (2008 & Supp. 2016) ("A limited liability company is formed when the certificate of organization becomes effective and at least one person has become a member.").

179. "A limited liability company is formed when its articles of organization become effective." COLO. REV. STAT. ANN. § 7-80-207 (2015). Note that Colorado also has a provision stating that the LLC is formed by "delivering" articles of organization. COLO. REV. STAT. § 7-80-203(1) (2015).

180. *See, e.g.*, ARK. CODE ANN. § 4-32-102(11) (West 2011 & Supp. 2016) (defining

members.[191] There is no consensus on informational rights of members,[192] or on the requirements for a member to be allowed to transfer the right to join

191. There is a similar degree of variation with regard to the power of an operating agreement to modify the default fiduciary obligations of members in an LLC. Callison & Vestal, *supra* note 188, at 285-86.

the LLC as a member[193] (as opposed to merely transferring the economic rights in the business).[194]

Some states allow members to withdraw at will, while others provide that it takes a specific agreement to the contrary before members have this ability.[206] And in addition to those complexities, state statutes also vary as to the consequences of withdrawal when it is allowed.[207] The statutes list different events that can trigger dissolution by act of the members,[208] or by

F.3d 997 (8th Cir. 2007) (applying Minnesota law, and finding that it is likely that Minnesota courts would allow derivative actions even though the Minnesota LLC Act does not expressly authorize them); Bischoff v. Boar's Head Provisions Co., Inc., 436 F. Supp. 2d 626 (S.D.N.Y. 2006) (applying New York law and finding that LLC members have a common-law right to derivative actions); Tzolis v. Wolff, 884 N.E.2d 1005, 1016 (N.Y. 2008) (allowing a derivative action even though there

judicial intervention.[209] States even vary in how assets of the business are to be paid out in the event of dissolution and winding up of the business.[210]

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dissolution through "the affirmative vote, approval or consent of at least a majority in interest of the

C. Reform Efforts and Further Movement Away from Uniformity

Commentators have complained that "it is time to clean up the mess created by the proliferation of forms."[211] Ironically, many of those who are unhappy with the lack of uniformity and consistency are also advocating for new ideas or language, or even new forms of business at the same time.[212]

The ULC, in its on-going efforts to improve state LLC Acts and presumptively to aid in achieving a more uniform approach to business organization, is also making choices that seem counter-intuitive if uniformity is the objective.[213] For example, the ULC proposed the ULLCA in 1994, and

211. Larry E. Ribstein, *Making Sense of Entity Rationalization*, 58 BUS. LAW. 1023 (2003) (citing Thomas F. Blackwell, *The Revolution Is Here: The Promise of a Unified Business Entity Code*, 24 J. CORP. L. 333 (1999)). Other sources concerned about the increasingly complex array of organizational options include William H. Clark, Jr., *What the Business World Is Looking for in*

original versions of the Arkansas, Idaho, Indiana, Louisiana, Kentucky, and Montana LLC acts.[240]

Without exception, these states have had multiple issues with the legislation modeled on the original prototype LLC Act. Arkansas has had to amend parts of its statute multiple times in order to address some of the more pressing issues created by the state's reliance on the draft prototype act.[241] Idaho repealed its statute in 2008.[242] Indiana has had to rewrite significant portions of its act to make it better fit the needs of businesses in the state.[243] Kentucky has also needed

other sections had to be amended or repealed in 2007,[247] 2011,[248] and 2013.[249] In addition, the Montana legislature has also consciously attempted to move forward with the ULLCA in this process, stating that "[t]he adoption of ULLCA will provide much needed consistency among the States, with flexible default rules, and multistate recognition of limited liability on the part of company owners. It will also promote the development of precedential case law."[250]

Clearly, the original Prototype LLC Act was not meant to be a final product, and in fact had been utilized by these states while it was only in draft form. It is not surprising, then, that many amendments and adjustments have had to be made. On May 1, 2011, the ABA Committee on Partnerships and Unincorporated Business Organizations, now renamed the Committee on LLCs, Partnerships and Unincorporated Entities of the ABA Section of Business Law, through its Subcommittee on Limited Liability Companies, released a Revised Prototype LLC Act.[251] Moreover, at least one of the principals in the drafting process has commented that prototype act 'is an ongoing project and will be updated from time to time as developments warrant.[252] Because the few states originally relied on the draft version of the prototype act generally had a less than satisfactory experience with the statutory language, and because the "revised" prototype act is promised as an on-going work in progress, it certainly seems unlikely that it will produce significant uniformity among the states.

It is doubtless true that the ULLCA (2013) is not a perfect statute either, with or without the hub-and-spokes structure proposed by the Commissioners as part of UBOC. It is, however, clear that many of the benefits of the LLC format will not be, and realistically cannot be, realized unless and until there is some consistency and constancy with regard to the statutory language among and between the states.[253] Moreover, the more uniform the rules are, the faster that statutory ambiguities can be resolved and the less expensive it

247. *E.g.*, MONT. CODE ANN. §§ 35-8-911, 35-8-1103, *repealed by* Mont. Laws of 2007, ch. 240, §§ 68, 70; MONT. CODE ANN. § 35-8-1103, *repealed by* MONT. LAWS 2007, ch. 240, §§ 68, 70.

248. *E.g.*, M

state legislatures are generally willing to defer to the substantial expertise and experience of the drafters of the uniform statutes.[256] It is, however, a lot to ask of states to expect them to continuously update and revise their business statutes, and in fact, it is almost certainly unrealistic to expect them to do so.

Instead, if we could settle on a less-then-perfect but far-better-than-chaos alternative, and allow states to enact the legislation over time, we have a