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Mark J. Loewenstein

University of Colorado Law School

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BUSINESS LAW TODAY

Rationalizing Entity Law: Corporate Law and Alternative Entities (Part I)

By Mark J. Loewenstein

In this article, I consider how corporate law and limited liability company law treat five different areas: agency authority, derivative actions, formation issues, veil piercing, and oppression of minority owners. For each such area, I consider whether the law varies depending on the kind of entity involved, why that might be the case, and whether the law should be rationalized; that is, whether legislatures or the courts should seek to harmonize the law across entities. While this short article focuses primarily on corporations and limited liability companies, the issues considered here apply as well to partnerships and, where appropriate, reference is made to partnership law.

Agency Authority

One striking difference between corporate law and the law of alternative entities relates to basic principles of agency law. Does the person purporting to act on behalf of the entity have the authority to bind the entity? Corporate statutes are not helpful in resolving this question. Typically, these statutes provide that corporate officers have such authority as is set forth in the bylaws or in a resolution of the board of directors (e.g., MBCA § 8.41). By contrast, alternative entity statutes – partnership and LLC acts – typically provide a statutory basis for concluding that an agent of the entity possessed the necessary authority to bind

the entity. The 1996 version of the Uniform Limited Liability Company Act (the ULLCA 1996) is typical in this regard, providing:

Each member [of a member managed limited liability company] is an agent of the limited liability company for the purpose of its business, and an act of a member, including the signing of an instrument in the company's name, for apparently carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company, unless the member had no authority to act for the company in the particular matter and the person with whom the member was dealing knew or had notice that the member lacked authority.

Such statutory provisions clothe the members with actual authority to bind the LLC, subject to action by the company to limit that authority. This provides some level of comfort to those who transact business with an LLC, while a person dealing with a corporate officer does so, arguably at least, at his or her peril.

The approach of ULLCA 1996, though sensible and reflective of the law in many jurisdictions, has been rejected in the 2006 version of the Uniform Limited Liability Company Act (ULLCA 2006) and the

ABA's Revised Prototype LLC Act (Prototype) in favor of the corporate model, limiting the authority of the actor to that set forth in the operating agreement. While the statutory law currently suggests a sharp difference between corporate law and the law of alternative entities, ULLCA 2006 and the Prototype suggest a trend in the direction of harmonization. Only time will tell if state legislatures (presumably prompted by bar association committees) will be persuaded to abandon the formulation in their partnership and limited liability company acts for the corporate model. It would make sense to do so.

One recent case, *Cain Family Farm L.P. v. Schrader Real Estate & Auction Co., Inc.*, 991 N.E.2d 971 (Ind. Ct. App. 2013) illustrates the potential contrast between corporate and LLC law. In this case, a family limited partnership owned farm land that was managed by a limited liability company, the general partner of the family limited partnership. The limited partners and the members of the LLC were four siblings, and they decided to sell the farm. They hired a firm to handle the transaction, but agreed among themselves that no sale could take place in the absence of a unanimous agreement among the four. One of the four siblings (Candace) took the lead and approved a sale without consulting her siblings, who then filed a declaratory

judgment action to determine whether the sale was binding on the limited partnership. The court held that it was, because the complaining siblings never communicated to any potential buyers that Candace lacked the authority to act on behalf of the LLC/general partner. More importantly, the business of the LLC was to manage the family limited partnership and her actions (approving a sale) were consistent with the carrying of the business of the LLC in the usual way. Thus, by virtue of the LLC act in Indiana, Candace had the apparent authority to act on behalf of the LLC/general partner and, consequently, to bind the family limited partnership. By contrast, if title to the property were held in a corporate name, the president of the corporation would not have the apparent authority to sell the property, although, by virtue of the bylaws or board action, might have the actual authority to do so.

Cain Family illustrates how corporate and LLC law might diverge, with the former affording less agency authority to key actors than the latter. The trend noted above may close this gap, which would be a sensible harmonization.

Derivative Actions

Universal Demand v. Demand Futility

Corporate law on derivative actions is far from uniform. For instance, some states require that demand be made in all instances, known as “universal demand” (see, e.g., MBCA § 7.41), while other states (generally by judicial decision) excuse demand if demand would be futile (see, e.g., *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)). Alternative entity law tends to embrace the demand futility concept, at least in statutory formulations. For instance, ULLCA 1996 provides, in § 1101:

A member of a limited liability company may maintain an action in the right of the company if the members or managers having authority to do so have refused to commence the action or an effort to cause those members or managers to commence the action is not likely to succeed.

ULLCA 2006 has also adopted the demand futility idea, while the Prototype has adopted the concept of universal demand, similar to the MBCA. There is not an obvious reason why corporate and LLC law should diverge on this point and the demand requirement presents an opportunity for harmonization.

Fee Shifting

Under the MBCA (Sec. 7.46), a court may order attorneys’ fees in favor of either party: for plaintiff “if [the court] finds that the proceeding has resulted in a substantial benefit to the corporation,” and for defendant “if it finds that the proceeding was commenced or maintained without reasonable cause or for an improper purpose.” ULLCA 1996 and early LLC acts tended to allow attorneys’ fees only for successful plaintiffs. As in other areas, ULLCA 2006 and the Prototype have embraced the approach of the MBCA, allowing either side to recover attorneys’ fees. This is similar to the state of the law with respect to the demand requirement.

Standing of Creditors to Maintain a Derivative Action

Whether a creditor has standing to maintain a derivative action is a function of statutory interpretation. In Delaware, for instance, creditors have been granted standing to maintain a derivative action when the corporation is insolvent. (*No. Amer. Catholic Educ. Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)). The relevant Delaware and MBCA statutory provisions are similar, providing that a derivative action may be commenced by a person who was a shareholder at the time of the conduct complained of or became one “through transfer by operation of law from one who was a shareholder at that time.” What these statutory provisions do not say is that a derivative action may only be commenced by a shareholder. The Delaware courts have noted this omission in ruling that only limited partners and members of limited liability companies, to the exclusion of creditors in those entities, may maintain derivative actions. The relevant

provision of the Delaware LLC Act, 6 Del. C. § 18-1001, provides, in the section titled “Proper Plaintiff”:

In a derivative action, the plaintiff *must* be a member or an assignee of a limited liability company interest at the time of bringing the action and: (1) At the time of the transaction of which the plaintiff complains; or (2) The plaintiff’s status as a member or an assignee of a limited liability company interest had devolved upon the plaintiff by operation of law or pursuant to the terms of a limited liability company agreement from a person who was a member or an assignee of a limited liability company interest at the time of the transaction. (emphasis added).

While this section looks similar to the Delaware (and MBCA) provision, the inclusion of the word “must” led the court to a different conclusion. The Delaware Chancery court went on to rationalize the difference in the treatment of a creditor of an LLC as compared to a corporate creditor: the former has more ways to protect itself contractually. The court noted that, for instance, an operating agreement can provide rights to creditors and can expand the duties that managers owe to creditors when the LLC is insolvent. While the claim that creditors can more easily protect themselves when dealing with an LLC may be questioned (the two cited examples could have corporate analogs), there is no doubt that the difference in statutory language justifies the difference in outcome.

This is an area where harmonization would make sense. Either creditors of all entities should have standing to maintain a derivative action, or none should.

Individual v. Entity Injury

The law is clear that derivative actions are only available to address injury to the entity. If the injury in question is suffered directly by the equity owner, such as the failure of a corporation to honor a contractual commitment to a shareholder, that action must be brought as a direct action. The structure of an alternative entity, as

compared to a corporation, means that, in some instances, the nature of the injury is characterized differently in the two types of entities. The classic example of this difference is reflected in *Anglo Amer. Sec. Fund v. S.R. Global Intern'l Fund*, 829 A.2d 143 (Del. Ch. 2003). In this case, the limited partners sued a limited partnership, its general partner, and the auditor of the limited partnership alleging a variety of claims flowing from the general partner's allegedly wrongful withdrawal of funds from its capital account. Ruling on a motion to dismiss, the court held that the limited partners' claims were not derivative claims, but direct claims. The court stated that "the test for distinguishing direct from derivative claims in the context of a limited partnership is substantially the same as that used when the underlying entity is a corporation. In both instances the determination is made by careful application of a rather nuanced test. The test looks to the nature of the injury and to the nature of the remedy that could result if the plaintiffs are successful." The court concluded, however, that the claims made by the limited partners in this case "state merely a diminution in value of the Fund's assets, which injures the limited partners only in proportion to their *pro rata* interest in the Fund," and are consequently direct claims. By contrast, the same claim made by corporate shareholders would be derivative claims.

Thus, at least in this area of derivative actions, harmonization seems inappropriate. The different nature of corporations and alternative entities, in particular the capital account feature of alternative entities, means that, in some instances, equity owners will suffer a direct loss from a breach of fiduciary duty by those in control of the entity.

Formation Issues

A number of judicial decisions have recognized the concepts of "de facto corporation" and "corporation by estoppel." The former concept involves a good faith or colorable attempt to comply with the applicable corporate statute and the use of the corporate power at a time when the incorporation was not perfected because,

for instance, the secretary of state rejected the filing. Jurisdictions that recognized this doctrine would treat the corporation as though it were validly formed, with the consequence that the persons exercising corporate powers could avoid personal liability. Under the concept of corporation by estoppel, a third party who knew that its counter-party had not yet formed corporation could be estopped from imposing personal liability on those who exercised corporate powers if the third party knowingly acted as though a corporation had been validly formed.

Corporate law has moved away from the concept of de facto corporations, in part because it has become easier to form corporations. For instance, the Official Comment to Section 146 of the 1969 version of the MBCA stated that the section was "designed to prohibit the application of any theory of de facto incorporation." Nevertheless, the most recent version of the MBCA includes a provision that may be interpreted as reviving the doctrine, at least in part. Section 2.4 of the MBCA provides:

All persons purporting to act as or on behalf of a corporation, *knowing* there was no incorporation under this Act, are jointly and severally liable for all liabilities created while so acting. (emphasis added).

Arguably, a person who filed or attempted to file articles of incorporation with the secretary of state and did not know that the filing had been rejected would not bear personal liability under this section. If that argument were to prevail, the result would be similar to that under the de facto doctrine.

LLC acts tend not to address the issue of personal liability of members for actions taken before the LLC has been formed, and courts have looked to corporate law to fill the void. (See, e.g., *Duray Development, LLC v. Perrin*, 792 N.W.2d 749 (Mich. App. 2010) recognizing that both de facto corporation and corporation by estoppel doctrines could be applied to LLCs).

In this area, then, corporate statutes are in conflict with one another on whether the doctrines are recognized, and when the issue aris-

es for an LLC, courts rely on corporate case law. This is an area ripe for harmonization.

Veil Piercing

Veil piercing in corporate law is a doctrine that is judicially created. Corporate statutes do not address the issue, and precedents recognizing the doctrine go back to the nineteenth century. The legal theory that underpins the veil piercing doctrine is that operating in the corporate form is a "privilege" (presumably granted by statute), and if that privilege is abused, the liability shield will not be recognized by the courts. Courts will find abuse if, for instance, those in control of the corporation do not adhere to the statutory formalities or otherwise fail to treat the corporation as a separate legal entity.

Alternative entities do not operate with the same formalities as do corporations. They are not required to hold annual meetings, have a board of directors, appoint officers, maintain minutes of meetings, etc. Rather, alternative entities are contractual entities, having such formalities, if any, as the parties agree to in their foundational agreements. Nevertheless, courts have readily applied the veil piercing precedents from corporate law to LLCs and, recently, to a limited partnership. These cases have recognized that failure to adhere to formalities cannot be a factor in applying the doctrine and have, instead, focused on whether the individuals controlling the entity have treated the entity as their alter ego. ULLCA 2006, while not expressly providing for veil piercing, does so indirectly, providing, in Section 304(b): "The failure of a limited liability company to observe any particular formalities relating to the exercise of its powers or management of its activities is not a ground for imposing liability on the members or managers for the debts, obligations, or other liabilities of the company." The Official Comment following this section confirms this: "This subsection does not preclude consideration of another key piercing factor – disregard by an entity's owners of the entity's economic separateness from the owners."

In the area of veil piercing, the courts are harmonizing the law, and justifiably so.

Oppression

Unlike veil piercing, shareholder oppression is not a concept wholly created by the judiciary, but it is close. In a closely held corporation, if the majority disappoints the reasonable expectations of the minority shareholders, those minority shareholders may have a cause of action to address that conduct. There is some statutory basis for this claim, as corporate statutes typically provide that, in a proceeding by a shareholder, a court may dissolve a corporation if the shareholder establishes that “the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, *oppressive* or fraudulent.” (MBCA Sec. 14.30(a)(2) (ii) (emphasis added). The courts have said that disappointing the reasonable expectations of the minority shareholder is oppressive conduct, entitling the shareholder to a decree of dissolution. But some courts have concluded that if the minority shareholder proves oppressive conduct (thus entitled to dissolution), the court has the equitable power to order a remedy other than dissolution. In Massachusetts, which does not even have such an oppression provision, the courts have found a general equitable power to address oppressive conduct with a remedy.

While there are few cases in which members of an LLC have sought a cause of action for oppression, the trend seems to be that the courts will recognize such a claim, Delaware being an exception. Many LLC statutes have a dissolution provision that is similar to the corporate provision quoted above, and that provides the necessary support for applying the doctrine.

As in the area of veil piercing, oppression is an example of judicially created harmonization. But just as veil piercing does not quite fit the LLC form, oppression is an even looser fit. LLCs are contractual entities and, arguably, parties can bargain for such protections as they desire. If the operating agreement identifies the expectations of the minority members, then their remedy, if any, for not receiving those expectations ought to lie in an

action for breach of contract. This is an area in which harmonization is not justified.

Conclusion

Corporate law and the law of alternative entities need not be harmonized solely for the sake of harmonization. I have tried to show some instances in which harmonization has already occurred, others where it makes sense for it to occur, and still others where harmonization makes little sense. While the end of the 20th century saw a significant increase in the number of entities available to the entrepreneur, the challenge of the 21st century will be to consider whether the legal differences among those entities makes sense and, if not, how the law should be harmonized.

Mark J. Loewenstein is Monfort Professor of Commercial Law at the University of Colorado Law School in Boulder, Colorado.