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WHAT'S IN A NAME?: AN ARGUMENT FOR A SMALL BUSINESS "LIMITED LIABILITY ENTITY" STATUTE (WITH THREE SUBSETS OF DEFAULT RULES)

Dale A. Oesterle*
Wayne M. Gazur**

The recent proliferation of small business entity forms is primarily a result of their tax characterization. With the recent adoption of the IRS "check-the-box" regulations and, as a consequence, the elimination of traditional tax distinctions, many of these forms have lost their appeal. This article proposes starting over with one form, the "limited liability entity." Part I discusses the history of small business forms. Part II analyzes the current forms in light of the recent check-the-box legislation. Part III discusses the necessity of and rationale behind a unified entity statute. Finally, Part IV outlines a unified limited liability entity statute with four alternative forms.

INTRODUCTION

In Colorado, our home state, the organizers of a small business can now choose one of nine domestic forms: a general partnership,¹ a limited liability partnership (LLP),² a limited partnership,³ a limited liability limited partnership (LLLLP),⁴ a limited liability company (LLC),⁵ a limited partnership association (LPA),⁶ a regular corporation,⁷ which

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1. COLO. REV. STAT. §§ 7-60-102 to -154 (Supp. 1996).

2. The limited liability partnership provisions are scattered throughout the general partnership statute. *See, e.g., id.* § 7-60-144 (Supp. 1996) (registration procedure); *id.* § 7-60-115(2) (nature of a partner's liability); *id.* § 7-60-146 (limitation on distributions); *id.* § 7-60-153 (application of case law under which corporate veil of a corporation may be pierced).

3. *Id.* §§ 7-62-101 to -1104.

4. The limited liability provisions are woven into the limited partnership statute. *See, e.g., id.* § 7-62-403(2)(a) (liability of a general partner); *id.* § 7-62-1104 (registration provisions).

5. *Id.* §§ 7-80-101 to -1101.

6. *See id.* § 7-63-101 to -117. For a discussion of early limited partnership association law, see Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*,

in turn can be taxed under subchapters C or S⁸ of the Internal Revenue Code, a professional corporation (PC),⁹ and a cooperative.¹⁰ If this is not enough, the organizers can look across the border and choose to be a Wyoming statutory business trust.¹¹ Colorado's situation is, of course, not unique; it is replicated in most states,¹² but for the details. This array of choices presents a false richness.

Initially the stakes were high. Drafters of the new small business forms aimed to decouple limited liability from a corporate level tax. Through the new forms organizers avoided classification as an "associ-

41 CASE W. RES. L. REV. 387, 393-94 (1991). The LPA statutes were enacted in Colorado to serve primarily as an estate planning structure. See *infra* text accompanying notes 188-92.

7. COLO. REV. STAT. §§ 7-101-101 to 7-117-105 (Supp. 1996). For jurisdictions with close corporation statutes, that is an additional alternative.

8. Of course, while regular C corporation status is available to almost all comers (except for special cases like insurance companies, mutual funds, and tax exempt corporations), the S corporation provisions are unavailable for certain types of corporations and shareholdings. See generally I.R.C. §§ 1361-1398 (1994).

9. In Colorado, a professional corporation is organized under the general corporation statute, COLO. REV. STAT. §§ 7-101-101 to 7-117-105, but the articles of incorporation must also include additional prescribed provisions pertinent to the provision of professional services. For law firms, the additional provisions are contained in Colorado Supreme Court Rule 265. COLO. R. CIV. P. 265. For other professions, the additional provisions are prescribed by statute. See, e.g., COLO. REV. STAT. § 12-2-117 (Supp. 1996) (accountants); *id.* § 12-4-110 (architects); *id.* § 12-33-124 (chiropractors).

10. See COLO. REV. STAT. §§ 7-56-101 to -901 (Supp. 1996). Although agricultural marketing cooperatives remain a clear subject of the legislation, after the July 1, 1996, amendments, the statute also "enable[s] all types of industries and enterprises to avail themselves of the benefits of the cooperative form of doing business in accordance with the provisions of this article." See *id.* § 7-56-102(c). Inasmuch as the organizational provisions refer to articles of incorporation, incorporators, stock, and shareholders, see *id.* § 7-56-201, and the provisions of the general incorporation act shall apply to matters not otherwise addressed, see *id.* § 7-56-507(1), it would appear that a cooperative would be sufficiently "describe[d] or refer[red] to . . . as incorporated or as a corporation" for purposes of the per se corporate tax characterization under the new check-the-box regulations. See Treas. Reg. § 301.7701-2(b)(1) (1996). Special federal taxation provisions govern the taxation of cooperatives, including an income exclusion for net profits (if any, particularly if transactions are at cost) paid out in the form of patronage dividends that can minimize the tax on any net profits. See I.R.C. §§ 1381-1388 (1994). It is difficult to predict whether the cooperative form will be embraced by users outside the traditional commodity focus in which members are returned portions of the net profits of the cooperative on some formula, often based upon "patronage" reflected by the level of sales to, or purchases from, the cooperative.

11. See Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, 66 U. COLO. L. REV. 881, 914-17 (1995) (discussing the Delaware and Wyoming statutory trust provisions). Connecticut has joined Delaware and Wyoming in enacting statutory business trust legislation, effective October 1, 1997. See Connecticut Statutory Trust Act, 1996 Conn. Acts, Pub. Act No. 96-271, §§ 219-253 (Reg. Sess.). While not a full statutory trust act, Washington, by statute, recognizes the validity of the Massachusetts business trust. See WASH. REV. CODE ANN. §§ 23.90.030, .040, .050, .060, .900 (West 1994).

12. All 50 states have some form of general partnership, limited partnership, LLC, and corporation-enabling legislation. At this time, at least 41 states and the District of Columbia have LLP legislation. See *infra* note 21.

ation" taxable as a corporation.¹³ For a decade, the IRS, through incremental revenue rulings,¹⁴ revenue procedures,¹⁵ and private letter rulings,¹⁶ gradually relaxed its definition of association. With each new IRS ruling, states added to or amended their statutes. But then the IRS proposed to change the basic rule, and thus the game. Its willingness to make pass-through treatment available to all unincorporated associations, irrespective of internal structure, through the implementation of its so-called "check-the-box" regulations¹⁷ has lowered the

13. The corporate income tax is imposed on every "corporation." See I.R.C. § 11(a) (1994). In turn, "[t]he term 'corporation' includes associations, joint-stock companies, and insurance companies." *Id.* § 7701(a)(3). The income tax treatment of unincorporated associations as either partnerships or corporations was guided by the Treasury regulations. See Treas. Reg. § 301.7701-1 (1977); *id.* § 301.7701-2 (1993); *id.* § 301.7701-3 (1995). While the Service was not very successful in the judicial arena in characterizing entities as corporations, see, e.g., *MCA Inc. v. United States*, 685 F.2d 1099, 1101 (9th Cir. 1982); *Larson v. Commissioner*, 66 T.C. 159 (1976); *Zuckman v. United States*, 524 F.2d 729, 733 (Ct. Cl. 1975); the severe consequences attendant to such characterization ensured attention to avoid such a result. The measures included opinion letters of counsel concerning the characterization issue, careful attention to the language and structure of partnership agreements, and practitioner attentiveness to the changing positions of the Service as demonstrated in rulings and procedural announcements. The area has been a field day for continuing legal education program sponsors and academic writers. See, e.g., AMERICAN LAW INST., FEDERAL INCOME TAX PROJECT, SUBCHAPTER K: PROPOSALS OF THE AMERICAN LAW INSTITUTE ON THE TAXATION OF PARTNERS 377, 386 (1984) (stating that a limited partnership that has a corporate general partner with insignificant assets should not be taxed as a corporation); Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105 (1991) (proposing taxation of entities based on the distinction between large business ventures and small ones); Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 565 (1995) (proposing the elimination of partnership classification regulations when taxing domestic LLCs and limited partnerships); Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437 (1995) (discussing the failure of the corporate resemblance test); Fred W. Peel, *Definition of a Partnership: New Suggestions on an Old Issue*, 1979 WIS. L. REV. 989 (exploring legislative and regulatory possibilities for improving the characterization issue).

14. See, e.g., Rev. Rul. 88-76, 1988-2 C.B. 360; Rev. Rul. 93-38, 1993-1 C.B. 233; Rev. Rul. 93-91, 1993-2 C.B. 316.

15. See, e.g., Rev. Proc. 95-10, 1995-3 I.R.B. 20.

16. See, e.g., Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991).

17. On May 9, 1996, the IRS issued proposed regulations that would implement the so-called "check-the-box" proposal for entity income tax classification. See Prop. Treas. Reg. §§ 301.7701-1 to -4, 61 Fed. Reg. 21,989-97 (1996). These proposed regulations were finalized in December 1996. T.D. 8697, 61 Fed. Reg. 66,584 (1996). Essentially, an unincorporated domestic association will be treated as a partnership as a default matter. Treas. Reg. §§ 301.7701-1 to -3 (1996). However, the entity can affirmatively elect to be treated as a corporation for income tax purposes. *Id.* § 301.7701-3. A one-member association is, as a default matter, not treated as a taxable entity; it can affirmatively elect corporate status. *Id.* This resolves the prior uncertainty concerning the treatment of one-member LLCs. See generally Scott E. Grimes et al., *Proposed Entity Classification Regs. Greatly Simplify Rules*, 25 TAX'N FOR LAW. 68 (1996) (discussing the current classification regulations and the implications of the proposed classification regulations). There is a lot of optimism about the practical effects of the IRS liberalization. A practicing real estate attorney reportedly "wonders if the new regulations will

stakes. Tax savings through choice of form are now, with the exception of estate and employment taxes, minimal.

The new forms are now enjoyed only by legal hobbyists, who debate their microscopic differences with relish and seriousness. Others find the still-developing maze of alternate forms of business organization difficult to navigate and unduly costly. There are needless opportunities for error. Those lawyers and clients who have to choose among them and work with them suffer the inconvenience and confusion of yet another example of an excess of law and lawyering.

Moreover, the choices among current statutory forms are irrational. Three controlling influences commingle to create a bizarre system of small business classification. First, many of the statutes still contain obsolete provisions based on the old IRS definition. Second, the *title* attached to a small business form—company, partnership, or corporation—affects the treatment of the business under a wide variety of other regulatory statutes—liquor licenses, for example, which are themselves also now obsolete. Third, those amending the various statutory forms are driving all forms toward each other. The drafters are attempting to allow businesses to register under whatever title they need for external regulatory advantage and, at the same time, contract specifically for the internal form of organization they prefer.

We need to start from scratch. Without the income tax-dictated facets of the entities, it is now easier to construct a business organization statute that is internally coherent, flexible, understandable, and consistent with organizers' intuitive sense of how the structure should work. In that regard, we propose guidelines for such legislation.

I. A SHORT HISTORY OF THE RAPID MUTATION AND PROLIFERATION OF SMALL BUSINESS FORMS

A. *The Breach in the Dam: The 1988 IRS Revenue Ruling on the Wyoming LLC*

The success of the LLC was the catalyst for change. Once the federal income tax consequences of the Wyoming LLC were somewhat assured by a 1988 IRS revenue ruling,¹⁸ the number of adopting states

spark a real estate boom similar to the explosion of the 1980s, which was partly driven by changes in the tax law." Paula Moore, *Proposed Regulations Would Simplify Deals*, DENV. BUS. J., May 31, 1996, at 6A. "The regulations 'will level the playing field' for small-firm general practitioners, says Mark Ferguson of Charleston, West Virginia, a tax attorney who helped draft his state's LLC statute." James L. Dam, *Tax Lawyer Specialists Are No Longer Needed for LLCs*, LAW. WKLY. USA, June 3, 1996, at 1. While the formation and entity characterization issues are simplified, the tax lawyers will still have a full menu with language for special allocations of losses, passive activity loss limitation planning, and estate planning considerations, to name but a few.

18. The revenue ruling according partnership income tax treatment to the Wyoming LLC, Rev. Rul. 88-76, 1988-2 C.B. 360, produced some certainty of result. That ruling was the first of many, which became gradually more liberal. See Wayne M. Gazur, *The Limited Liability Company Experiment: Unlimited Flexibility, Uncertain Role*, 58

rose from two in early 1990 to fifty (plus the District of Columbia) by 1996.¹⁹ The LLC was propelled through legislatures by a force of accountants, tax lawyers, and business development lobbies that met little organized opposition.²⁰ Although sharing both partnership and corporate characteristics, the LLC was a new entity. The newness appeared to be part of the allure, and there was little scholarly debate over the desirable contours of the legislation in advance of enactment.

With the LLC "gold standard" of pass-through income taxation and limited liability for all, one might have predicted that other existing forms would either need to change or become unimportant. The former prediction was correct. Limited liability was extended to general partners of general partnerships under LLP legislation which quickly spread across the United States.²¹ In some states, the limited liability shield was extended to the general partners of even limited partnerships.²² The impetus for these new partnership forms was an odd combination of inertia and progressiveness. Lawyers and their clients were comfortable with partnerships and limited partnerships. Their organizational form and the legal doctrines that controlled both internal and external relationships among participants, although moving at the margins, were more or less established and known. Rather than jump to a new entity ("Anyone have a good draft LLC operating agreement?"), why not just add limited liability by statute to an old favorite? As a result, LLPs and LLLPs were born.

Indeed, our jump to LLPs and LLLPs after the LLC became ubiquitous suggests that the LLC is a historical accident. The LLC gained acceptance after the Wyoming statute, largely ignored for eleven years,²³ was the subject of a favorable ruling by the IRS in 1988.²⁴

LAW & CONTEMP. PROBS. 135, 139-43 (1995) (summarizing the history of the rise of the LLC).

19. See Bruce D. Ely & Joseph K. Beach, *The LLC Scoreboard*, 72 TAX NOTES 119, 119-24 (1996); Gazur, *supra* note 18, at 140-41.

20. See Gazur, *supra* note 18, at 176-84 (describing the political constituencies involved in the rise of the LLC).

21. Presently, jurisdictions with some form of limited liability partnership legislation include: Alabama, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, and Wisconsin. See Ely & Beach, *supra* note 19, at 119-24 (listing states with LLC and LLP legislation and pending proposals as of May 24, 1996). For a critical evaluation of the LLP, see Robert R. Keatinge et al., *Limited Liability Partnerships: The Next Step in the Evolution of the Unincorporated Business Organization*, 51 BUS. LAW. 147 (1995).

22. See, e.g., COLO. REV. STAT. §§ 7-62-101(12), -403(2) (Supp. 1996); DEL. CODE ANN. tit. 6, § 17-214 (Supp. 1996); MICH. STAT. ANN. §§ 20.46, 20.1403(b) (Law. Co-op. 1990 & Supp. 1996); TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 2.14(a) (West Supp. 1996).

23. Prior to the second wave of LLC statute enactments which began in 1990, only Florida, in 1982, had joined Wyoming in enacting such legislation. Gazur, *supra* note 18, at 140.

States rushed to adopt a version of the Wyoming LLC and later models based on this and later rulings. There was caution, occasionally excessive,²⁵ in this progression. Had instead an LLP statute or an LLLP statute been the first presented to the IRS staff and received similar administrative approval, we probably would never have witnessed the growth of the LLC. We are better off perhaps with history as it is, however, because the birth of the LLC has us rethinking the organization attributes of small business in ways that a simple evolution of partnerships into LLPs may never have.²⁶

There has been other experimentation with new entities, but it is modest. Delaware and Wyoming have adopted a business trust statute,²⁷ and Colorado adopted a limited partnership association statute.²⁸ Perhaps we are approaching a period of some reflection, a lull after the LLC frenzy in which to digest the check-the-box approach. In the wake of final IRS adoption of those regulations, it is likely that many states will tinker with their LLC statutes.²⁹ Also, legislation has been introduced in Pennsylvania, and planned for other states, that would coordinate certain aspects of business entity structures without limiting the number of available choices.³⁰

24. Rev. Rul. 88-76, 1988-2 C.B. 360. For a discussion of this ruling, see *supra* note 18.

25. The preoccupation with foreign state recognition of the LLC entity ("We will not use the LLC until all, or most all, states have adopted it") seemed unnecessary. Although predictions are hazardous, it would seem that foreign state recognition of the LLC entity would be encouraged by principles of comity, by conflicts of laws principles that apply the laws of the state of incorporation, and by interpretations of the U.S. Constitution's Interstate Commerce Clause. See generally Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 447-56 (1992) ("[I]n actions against an LLC in a foreign jurisdiction, the foreign court should treat the LLC as though it were a foreign corporation and should apply the limited liability provisions of the LLC's state of organization.").

26. See Oesterle, *supra* note 11.

27. For a discussion of the statutory business trust, see *supra* note 11 and accompanying text.

28. For a discussion of Colorado's LPA statute, see *infra* notes 188-92 and accompanying text.

29. States prohibiting the formation of one-member LLCs will probably move to permit them, now that the federal income tax treatment is favorable. See *supra* note 17. In addition, now that attributes such as dissolubility or member management are no longer relevant to the income tax characterization inquiry, those state law aspects could be modified.

30. See S. 1506, 180th Leg., Reg. Sess. (Pa. 1996). The Pennsylvania proposal is organized in a so-called "hub and spoke" manner. Certain core features that are considered central to all business entities (general and limited partnerships, LLCs, and corporations) are propounded in a consistent manner as the "hub." The existing separate entity forms comprise the "spokes" and incorporate the common provisions of the hub. For a description of Pennsylvania's business corporations law by one of its drafters, see William H. Clark, Jr., *What the Business World Is Looking for in an Organizational Form: The Pennsylvania Experience*, 32 WAKE FOREST L. REV. 149, 156-73 (1997).

B. Choice Among States as Distinguished from Choices Within a State

1. Choice among states: our preoccupation with "uniform" state statutes

The proliferation of entity choices is, at some level, desirable. Each new entity is an experiment, and we gain information on each experiment's success or failure as time passes and entrepreneurs and professionals put the statutes to use. There is an important distinction, however, between choices among small business forms presented by differences among states and choices presented by differences among forms in any one state.

In theory, all states could have identical statutes which offer a multitude of interstate choices among various small business forms. This is what we, in large part, have now as states adopt minor variations of model or uniform acts prepared by national trade associations—the American Bar Association and the Commissioners on Uniform State Laws. There are model or uniform acts on corporations,³¹ close corporations,³² professional corporations,³³ general partnerships,³⁴ limited partnerships,³⁵ and limited liability companies.³⁶ There is even a model act for state anti-takeover legislation.³⁷ We anticipate that model acts on LLPs and LLLPs will soon appear.³⁸

The advantages of model or uniform acts are often spoken of and well understood. The acts represent the studied knowledge of experts who can cull the best from existing legislation.³⁹ Individual states can rely on this expertise and have better laws. Moreover, with our national markets, there is an advantage for all participants in intrastate commerce when there is uniformity among states in regulations that impact commercial matters.⁴⁰ What is less well understood is that the uniform and model acts also have significant costs.

31. See REVISED MODEL BUS. CORP. ACT (1984).

32. See MODEL STATUTORY CLOSE CORP. SUPP. (1984).

33. See MODEL PROF. CORP. SUPP. (1984).

34. See UNIF. PARTNERSHIP ACT (UPA), 6 U.L.A. 238 (1995); REVISED UNIF. PARTNERSHIP ACT (RUPA), 6 U.L.A. 8 (1995).

35. See UNIF. LTD. PARTNERSHIP ACT (ULPA), 6A U.L.A. 305 (1995); REVISED UNIF. LTD. PARTNERSHIP ACT (RULPA), 6A U.L.A. 59 (1995).

36. See UNIF. LTD. LIAB. CO. ACT (ULLCA), 6A U.L.A. 429 (1995).

37. See MODEL CONTROL SHARE STATUTE (1989).

38. An American Bar Association Working Group on Registered Limited Liability Partnerships has already produced a May 1995 draft of a Proposed Prototype Registered Limited Liability Partnership Act. Reportedly, the National Conference of Commissioners on Uniform State Laws has appointed a Uniform Limited Liability Partnership Act Drafting Committee that held its first meeting in November 1995. See ROBERT W. HILLMAN ET AL., GENERAL AND LIMITED LIABILITY PARTNERSHIPS UNDER THE REVISED PARTNERSHIP ACT 301-02 (1996).

39. See Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and Limited Liability Companies*, 66 U. COLO. L. REV. 947, 961 (1995).

40. Michael D. Weiss, *Actually Shutting Down the Virtual Multistate Corporation*, 28 IND. L. REV. 607, 666 n.189 (1995).

Our obsession with "uniform" state statutes may restrict and retard an otherwise valuable and natural process of statutory evolution, the state against state game of legal leapfrog. With respect to the LLC, for example, Professor Ribstein has criticized the Uniform Limited Liability Company Act (ULLCA),⁴¹ arguing that the wide variation in state LLC statutes that preceded the uniform act would, if left alone, produce better legislation.⁴² Uniformity would result after some experimentation in the ordinary course when ultimately desirable, but ULLCA, he argued, would stunt the growth of the normal evolutionary process of state legislation.⁴³ His predictions are borne out in part, perhaps, as changes in the income tax rules have made the dissolution sections of ULLCA obsolete within months of their promulgation.⁴⁴

An inherent shortcoming of attempts at uniformity is that no drafting project is perfect, and either uniformity is sacrificed when adopting jurisdictions tinker with the model, or the statute suffers from outright errors or misguided compromises that stubbornly persist. The growth and evolution of partnership law under the Uniform Partnership Act (UPA) and Uniform Limited Partnership Act (ULPA) is evidence that the adoption of a uniform act introduces an inordinate amount of inertia for future changes.⁴⁵ UPA, for example, promulgated in 1914, contained cumbersome and confusing provisions on wrongful dissolution⁴⁶ and partnership by estoppel.⁴⁷ State experimentation with the troublesome sections was limited by their reluctance to tinker with a uniform act. The dissolution and estoppel provisions survived until 1994, when they were changed by a new uniform act, the Revised Uniform Partnership Act (RUPA), which made the dissolution provision more complex and more technical.⁴⁸ Had various states been experimenting over time with more workable provisions, we would not be in the mess we are in with RUPA.

2. *Choice of forms within a single state: the title trap*

A separate question is whether any single state should have one small business form or many. Our argument in favor of having a single statute is the subject of Part III below. As noted above, states have chosen to have many forms and the number is growing. As a conse-

41. UNIF. LTD. LIAB. CO. ACT (ULLCA), 6A U.L.A. 429 (1995).

42. See Ribstein & Kobayashi, *supra* note 39, at 949-53 (discussing a number of drawbacks posed by the uniform law).

43. See *id.* at 951-52.

44. See *id.* at 970-71.

45. The Uniform Partnership Act was adopted in 1914, UNIF. PARTNERSHIP ACT (UPA), 6 U.L.A. 127 (1995), and revised in 1994, REVISED UNIF. PARTNERSHIP ACT (RUPA), 6 U.L.A. 3 (1995). The Uniform Limited Partnership Act was adopted in 1916, UNIF. LTD. PARTNERSHIP ACT (ULPA), 6A U.L.A. 305 (1995), and revised in 1976 and 1985, REVISED UNIF. LTD. PARTNERSHIP ACT (RULPA), 6A U.L.A. 2 (1995).

46. UNIF. PARTNERSHIP ACT (UPA) § 38, 6 U.L.A. 880; *id.* § 41, 6 U.L.A. 968-69.

47. *Id.* § 16, 6 U.L.A. 501.

48. See REVISED UNIF. PARTNERSHIP ACT (RUPA) §§ 601-807, 6 U.L.A. 72-104.

quence, the current system provides an intriguing mix of established, predictable law, on the one hand, and highly flexible, uncharted alternatives on the other. The former is found in corporate codes and, with some circumscribed alterations like the LLP changes, in the partnership acts. The LLC is the best example of the latter. In any system with multiple entity choices, the undesirable choices will fall from favor over time and become irrelevant. Recall the joint-stock association (or company),⁴⁹ the statutory partnership association,⁵⁰ and the Massachusetts business trust.⁵¹ They have not, for some time, been on the list of organizational alternatives for most practitioners.

If a new or improved form of business entity becomes dominant, existing forms can enter the dustbin of history even without legislative action. In the long run that will be the result, but one cannot minimize the costs of maintaining the professional and administrative knowledge base during the period of decline. If forms have outlived their usefulness or are redundant, it is wasteful to spend additional resources on perpetuating them.

At present, to be effective business counselors, Colorado lawyers must learn in some detail the advantages and disadvantages of the nine possible small business forms and communicate that information accurately to their clients. Most academics are comfortable with the proposition that states ought to provide different sets of default rules for small business organizations. At issue is how we get there. Drafters designed the current forms primarily around tax avoidance and that rationale has evaporated. Pure concerns of organizational structure were often an afterthought. These new entities consequently are not those that we should look to for our different sets of default rules. In a very real sense, we have yet to draft them.

With the importance of the differences between the current forms diminished substantially by the IRS proposal, one wonders whether the struggle to stay informed on whether state filing fees are lower for LLCs than corporations, or on whether a state liquor license law includes LLCs, is worth the effort. The liquor license question has been raised in an Oklahoma proceeding, *Meyer v. Oklahoma Alcoholic Beverage Laws Enforcement Commission*.⁵² Ms. Meyer sought a retail package store liquor license to be held by an LLC, but the Oklahoma Alcoholic Beverage Laws Enforcement Commission determined that an LLC is not entitled, under the Oklahoma Constitution, to receive and

49. For a discussion of the history of the joint-stock company, see William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 872-77 (1995).

50. The statutory partnership association has recently been reborn in Colorado. See COLO. REV. STAT. §§ 7-63-101 to -117 (Supp. 1996).

51. For a discussion of the Massachusetts business trust, see Herbert B. Chermide, Jr., Annotation, *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R.3d 704 (1978).

52. 890 P.2d 1361 (Okla. Ct. App. 1995).

hold such a license.⁵³ The district court reversed the commission's ruling, but on appeal the commission's position was sustained.⁵⁴

The Oklahoma Alcoholic Beverage Laws Enforcement Commission based its ruling on language of the Oklahoma Constitution, which suggested that licenses could be issued only to "any person or general or limited partnership."⁵⁵ Inasmuch as the opinion does not discuss this point, it apparently was considered well-settled by the appellate court that "person" in this context referred only to individuals.⁵⁶ In that posture, the issue was whether an LLC is a "general or limited partnership,"⁵⁷ and Ms. Meyer's counsel, not surprisingly, argued that an LLC is a partnership.⁵⁸ The appellate court's response was in part title driven; "the act creating the business form [the LLC] is in Title 18, which is entitled 'Corporations.'"⁵⁹ However, in this instance the court did look behind titles. Individuals, partnerships, and limited partnerships share the common characteristic that at least one party has liability for business obligations.⁶⁰ In contrast, all members of an LLC enjoy limited liability.⁶¹ The court concluded: "Our examination of the pertinent constitutional provisions leads us to conclude that their evident purpose was the assignment of personal responsibility for compliance with the liquor laws. Thus, business forms that did not insure such personal responsibility were excluded from eligibility for licensing."⁶² Do limited partnerships with a corporate general partner qualify? It depends on how literally the Oklahoma courts read the constitutional term "limited partnership." Consider the result if Oklahoma had adopted LLP or LLLP legislation, removing liability for all partici-

53. *Id.* at 1362.

54. *Id.* at 1362, 1364.

55. OKLA. CONST. art. XXVIII, § 4.

56. We are not Oklahoma constitutional law scholars. However, in other parts of the constitution, the reference to "persons" appears to be in reference to individuals. *See, e.g., id.* art. IX, § 15 ("A Corporation Commission is hereby created, to be composed of three persons, who shall be elected by the people at a general election for State officers . . ."); *id.* art. V, § 46 ("The Legislature shall not, except as otherwise provided in this Constitution, pass any local or special law authorizing . . . changing the names of persons or places . . ."); *id.* art. II, § 27 ("Any person having knowledge or possession of facts that tend to establish the guilt of any other person or corporation under the laws of the state shall not be excused from giving testimony or producing evidence . . ."). In one context the meaning of person is expanded to include "individuals, partnerships, and corporations," suggesting that the regular meaning is more circumscribed. *See id.* art. IX, § 34.

57. The Oklahoma Constitution also prohibits the issue of a retail package store or wholesale distributor's license to a "corporation, business trust or secret partnership." *Id.* art. 28, § 10. Rather than holding that an LLC is like a "corporation" and thereby prohibited from holding a license, the opinion finds that an LLC is not a partnership and is not therefore eligible in that manner. *Meyer*, 890 P.2d at 1363-64.

58. *Meyer*, 890 P.2d at 1363.

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.* at 1364.

pants. With such convergence of the forms, Ms. Meyer had a better argument had she used a title that more closely matched the constitutional language and gave her limited liability—an LLP.

The state liquor law example illustrates a hidden problem with multiplying forms. Taxing authorities, law enforcement, and other government institutions that will deal with small business entities must also invest resources in learning about the new entities.⁶³ Until legislation affecting businesses catches up with the new forms,⁶⁴ choices among the forms will not depend on the inherent quality of the forms themselves, but on the status of immature, relevant doctrines in related fields. The popularity of the business trust as an investment vehicle is in part reportedly attributable to its acceptability for banking and mutual fund regulatory purposes and to investors “burned” by investments bearing other titles like the “limited partnership.”⁶⁵

Other examples are not hard to find. Are LLC memberships securities?⁶⁶ Is the self-employment tax applicable to LLCs?⁶⁷ What is the

63. The Federal Trade Commission, for example, reportedly has taken the informal position that an LLC is to be treated as a corporation, rather than as a partnership, for Hart-Scott-Rodino notification purposes. See Robert R. Keatinge & Allan G. Donn, *LLCs and LLPs: Distinctions that Do Make a Difference*, 3 J. LIMITED LIABILITY COMPANIES 3, 6 (1996).

64. The 1990 Act establishing the Colorado LLC included 17 pages of amendments to a variety of Colorado statutes, generally adding the term “limited liability company” to existing lists of business entities in numerous contexts. Colorado Limited Liability Company Act, 1990 Colo. Sess. Laws 414. Such measures address many of the obvious problems, but not all.

65. I’ve been involved in several deals which used business trusts, both common law trusts and statutory trusts. In each of these deals, the parties were institutions. In some cases, the institutions could not invest in partnerships because of restrictions in their charters (e.g., mutual funds can typically buy trust interests but not partnership or LLC interests). I was also involved in a public commodities fund structured as a Delaware business trust. The underwriters didn’t want to sell partnership interest for marketing reasons.

Steven G. Frost, *Limited Liability Companies and Partnerships* (posted Nov. 1, 1996) <<http://www.ljextra.com/maillinglists/lnet-llc/1657.html>>.

My recollection was that historically many US banks used business trusts to own real property because their charters prohibited direct ownership of real estate and/or investments in partnerships.

We have also seen business trusts used in lieu of limited partnerships for marketing reasons. Since the late 1980s and into the 1990s, many promoters are loath to use limited partnerships because of the negative connotations in the syndication markets. Business trusts are sometimes viewed as an alternative.

Thomas C. Bell, *Limited Liability Companies and Partnerships* (posted Nov. 1, 1996) <<http://www.ljextra.com/maillinglists/lnet-llc/1658.html>>.

66. Since LLC ownership interests are not “stock,” they are not expressly listed under the definition of “security” under the Securities Act of 1933, 15 U.S.C. § 77b(1) (1994), but may meet the definition of an “investment contract,” which is expressly listed. *Id.* The question, “What’s in a name?,” is significant, at least initially, in this inquiry. This issue is also important for state (“Blue Sky”) securities law regulatory purposes and has generated a lot of commentary. See, e.g., Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possi-*

citizenship of an LLC for federal diversity jurisdiction?⁶⁸ Is a state statutory provision that dissolves an LLC upon a bankruptcy petition by a member enforceable in a Chapter 11 bankruptcy proceeding to terminate the debtor's LLC membership?⁶⁹ Can LLC members opt out

ble Steps to Encourage This Result, 45 HASTINGS L.J. 1223, 1304 (1994) (arguing that "a presumption against application of the federal securities laws seems justified if the LLC is truly to be a boon to the small business"); Park McGinty, *The Limited Liability Company: Opportunity for Selective Securities Law Deregulation*, 64 U. CIN. L. REV. 369, 371 (1996) (suggesting that "Congress amend the securities laws to allow participants in LLCs to choose whether to be covered"); Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807, 810 (1994) (stating that "LLC interests, like partnership interests, should be at least strongly presumed not to be 'securities'"); Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069, 1102-03 (1992) (concluding that LLCs are not securities under most instances); Elaine A. Welle, *Limited Liability Company Interests as Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws*, 73 DENV. U. L. REV. 425, 494 (1996) (arguing that each LLC offering must be analyzed on a case-by-case basis until legislatures expressly state that all LLC interests are securities); Robert R. Joseph, Comment, *Should Interests in Limited Liability Companies Be Deemed Securities?: The Resurgence of Economic Reality in Investment Contract Analysis*, 44 EMORY L.J. 1591, 1630 (1995) (arguing that a "needs-based" analysis should be applied to determine whether an LLC is a security); Jeffrey A. Mannisto, Comment, *Mississippi Limited Liability Companies: Potential Exposure Under Federal and State Securities Laws*, 64 MISS. L.J. 173, 198-99 (1994) (stating that LLCs should initially be presumed to be securities under Mississippi law, but the presumption is rebuttable when several conditions are met).

67. An important issue for small-business clients and their counsel is avoiding the federal employment taxes on self-employment income or wages. The IRS has proposed regulations that would treat income earned by all active members of a member-managed LLC as self-employment income. See *infra* note 100. This is a developing issue, and practitioners are proposing all sorts of avoidance structures, such as creating "subsidiary" LLCs that would hold the business assets, while funneling the income into a "parent" LLC; the hope is that the earnings from the lower tier would be considered as investment income rather than earned income. See Francis J. Mellen, Jr. et al., *Limited Liability Companies and Registered Limited Liability Partnerships in Kentucky: A Practical Analysis*, 22 N. KY. L. REV. 229, 310 (1995). Others would create classes of LLC interests without voting rights, to resemble a passive limited partner interest, thereby avoiding earned income classification. See *Are Lawyers in LLCs Exempt from Self-Employment Taxes?*, 82 J. TAX'N 190, 190 (1995). Others advocate the use of S corporations as members of the LLC. The potential self-employment income is arguably "laundered" by passing through the S corporation, where it emerges as undistributed S corporation taxable income, or as an S corporation dividend, neither of which is self-employment income. In that regard, aggressive distributions of earned income through the dividend route toward avoidance of employment taxes have met resistance in the courts. See, e.g., *Joseph Radtke, S.C. v. United States*, 712 F. Supp. 143, 146 (E.D. Wis. 1989), *aff'd*, 895 F.2d 1196 (7th Cir. 1990) (holding that "an employer should not be permitted to evade FICA and FUTA by characterizing all of an employee's remuneration as something other than 'wages'"). For a discussion of the self-employment tax issue in the context of S corporations, see *infra* note 109.

68. See, e.g., *Carlos v. Adamany*, No. 95C50264, 1996 U.S. Dist. LEXIS 5764 (N.D. Ill. Apr. 17, 1996) (mem.) (applying a "nerve center" test).

69. See, e.g., *In re Daugherty Constr., Inc.*, 188 B.R. 607 (Bankr. D. Neb. 1995) (holding that the Nebraska LLC statute dissolution provisions were not enforceable in bankruptcy). See generally James J. Wheaton, *Dumping Deadbeats: Enforcing Limited Liability Entity Agreements in Bankruptcy*, 3 J. LIMITED LIABILITY COMPANIES 60 (1996)

of workers' compensation coverage?⁷⁰ Is an LLC subject to state laws that prohibit pro se representation of "corporations"?⁷¹ Which entities get favorable estate tax valuation consideration under Internal Revenue Code § 2704?⁷² And so on.

Professors Ribstein and Kobayashi have recently made the point that states with a variety of statutes can serve a variety of "clienteles" who, for various reasons, group in one or more of the forms.⁷³ States without the smorgasbord will be at a "competitive disadvantage."⁷⁴ The examples they cite, however, may demonstrate that specific groups often choose selected forms, not because of their internal advantages, but because of how they fit in other regulatory systems, many of which are themselves obsolete or immature. In other words, the new forms may encourage ossification of obsolete classification systems by allowing specific targeted groups to use novel forms of business entities to avoid the regulation. We would prefer it the other way around, that obsolete classification systems be the systems that are modernized.

Professional firms provide a unique case, preferring the LLP form largely because of client perceptions.⁷⁵ Hot-shot lawyers in firms are "partners," not "members." So, due to client perceptions, law firms would rather be LLPs. This is an argument in support of two statutes of identical provisions on internal governance, perhaps with different entity *titles*. However, this is not an argument in support of two entities with different sets of default rules. Indeed, the push to "open up" the mandatory provisions of partnership statutes (and thus, to make them more like the LLC statutes) is a direct response to this phenomenon. In sum, the claim that specified "clienteles" need different entity statutes is not necessarily an argument that specified groups are deciding among different entities based on different sets of default rules on the matters of internal corporate governance.

(noting the conflicting views held by courts in these cases and urging nonbankrupt partners and members to take precautions to avoid adverse bankruptcy decisions).

70. See, e.g., COLO. REV. STAT. § 8-41-202 (Supp. 1996) (extending to LLC members the opt-out privilege enjoyed by corporate officers).

71. See, e.g., *Poore v. Fox Hollow Enters.*, C.A. No. 93A-09-005, 1994 Del. Super. LEXIS 193 (Del. Super. Ct. Mar. 29, 1994) (stating that an LLC, like a corporation, must be represented by a licensed attorney), *aff'd sub nom.* *Poore v. Unemployment Ins.* Appeal Bd., 1994 Del. Super. LEXIS 375 (Del. Super. Ct. Aug. 3, 1994).

72. For a discussion of I.R.C. § 2704, see *infra* notes 163-72 and accompanying text. The LLC and the limited partnership (as well as the limited partnership association) are competing structures for family estate planning. See *infra* Part III.E.

73. See generally Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 ECON. INQUIRY 464, 469-70 (1996) (suggesting an expanded role for unguided jurisdictional competition and less reliance on centralized uniform lawmaking).

74. *Id.*

75. Although admittedly anecdotal, the authors have heard of several Colorado law firms that switched from LLC to LLP status, in part because of the familiarity with partnership law, but also because of the "partner" title. On the other hand, some commentators have been somewhat critical of the LLP in comparison with the LLC. See Keatinge et al., *supra* note 21, at 203-04.

With the current proliferation of new entities, some may wonder why we should not take a breather and see how what we have will work out. Under normal circumstances, the argument would have real bite. We are not under normal circumstances. Most of the new entities were created to take advantage of a moving interpretation of a provision of the Internal Revenue Code. The provision has been simplified, knocking the underpinnings out of the rationale for most of the new entities. If the entities survive, alternative rationales will be found, and if found, the new rationale will require that the statutes be amended to correspond better to the new policy foundations.

II. A CRITICAL ANALYSIS OF THE CURRENT FORMS OF ORGANIZATION

The IRS's check-the-box regulations have eliminated, at least among unincorporated business associations, the need to design business forms around the federal income tax definition of "association."⁷⁶ The focus in choice among entities ought to shift in large part to the entities' organizational characteristics. Do the entities provide rules that optimize the effectiveness of structure for a substantial group of potential users? If this question dominates entity choice, then we would expect to see real, substantial differences in internal structure among the entities, giving potential users of all stripes real choices in form.

Unfortunately, as noted above, entity characterizations, primarily based on titles ("corporation" or "partnership"), also can have an impact on a firm's treatment under a variety of collateral tax and regulatory systems. If these external characterizations dominate entity choice, then we should expect to see drafters amend the various entities so that they all gravitate toward a basic set of principles, which provide for a substantial amount of individual modification. The real choice is among titles, not the substance of the structure. Users pick a title and then customize a basic provision to address individual organizational needs.

Current efforts to amend the entities, which will continue apace with the new tax context for the unincorporated entities, seem to exhibit both tendencies. However, our view is that the second trend, that of reforming entity statutes to look like each other, seems to have more strength. The newest revisions in partnership law, RUPA, and in LLC statutes have both forms gravitating towards each other.

A. *Sole Proprietorship*

In the past, a sole proprietor seeking limited liability would probably choose a corporation as the business vehicle. The taxation of the

76. If a business entity is organized under a statute which "describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic," the entity will be characterized as a corporation for federal income tax purposes and the organizers cannot elect to the contrary. Treas. Reg. § 301.7701-2(b)(1) (1996); *id.* § 301.7701-3(a).

one-member LLCs was uncertain,⁷⁷ and a number of states did not permit one-member LLCs as a matter of state law.⁷⁸ Although the sole proprietor/sole shareholder could elect S corporation status to achieve some pass-through taxation benefits, the S corporation is less flexible than a partnership from an income taxation standpoint.⁷⁹ Moreover, the creation of a separate corporate entity creates additional complications, such as compliance with state law corporate formalities and wage withholding compliance burdens (including the payment of federal and state unemployment taxes).

The check-the-box regulations treat one-member LLCs as a non-entity for federal income tax purposes—essentially a sole proprietorship but with limited liability.⁸⁰ With the income tax consequences of a one-member LLC confirmed as those of a sole proprietorship, there are few reasons, aside from the cost of forming and maintaining the entity, not to form an LLC to limit the organizer's personal liability.⁸¹ This factor should encourage more states to permit the formation of one-member LLCs. On the other hand, it will place a premium on LLC statutes that will permit a simplified formation and management structure to accommodate numbers of organizers who simply seek the limited liability shield without further complications.⁸² A recent quibble occupying the minds of some lawyers is, for example, whether a one-member LLC can have an "operating agreement" which is defined as an agreement signed among "members."⁸³

77. In Revenue Procedure 95-10, 1995-1 C.B. 501, 502, the Service stated that it would not consider a ruling request on the status of a one-member LLC, and that an LLC with fewer than two members would not be treated as a partnership for income tax purposes. For articles discussing this topic, see Jerry S. Williford & Donald H. Standley, *How Should Single-Member LLCs Be Classified for Federal Tax Purposes?*, 2 J. LIMITED LIABILITY COMPANIES 27 (1995); Francis J. Wirtz & Kenneth L. Harris, *Tax Classification of the One-Member Limited Liability Company*, 59 TAX NOTES 1829 (1993).

78. Single-member LLCs are permitted under state law in several states. See, e.g., ARIZ. REV. STAT. ANN. § 29-631 (West Supp. 1996); ARK. CODE ANN. § 4-32-201 (Michie 1996); CAL. CORP. CODE § 17050(a) (Deering 1996); COLO. REV. STAT. ANN. § 7-80-203 (West Supp. 1996); DEL. CODE ANN. tit. 6, § 18-201(a) (Supp. 1996); N.Y. LTD. LIAB. CO. LAW § 203(a) (McKinney 1996); OR. REV. STAT. § 63.044 (1995); TENN. CODE ANN. § 48-203-102(a) (1995); TEX. REV. CIV. STAT. ANN. art. 1528n, § 3.01 (West Supp. 1997).

79. For a discussion of how the S corporation is less flexible than a partnership, see *infra* note 109.

80. For a discussion of the check-the-box regulations, see *supra* note 17.

81. This is particularly true if the sole proprietor has employees who would subject him or her to vicarious liability for their tortious behavior during the course of their employment. Of course, the sole proprietor would remain exposed to liability arising from his or her own acts or omissions.

82. Filing the LLC papers just to attain limited liability would be unnecessary if limited liability were the default state of affairs. See Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 417-25, 475 (1992) (discussing the current regulatory costs of achieving limited liability status, and suggesting that "in the long run limited liability might come to be regarded as the residual business form, with individual liability reserved for firms that make special filings").

83. See, e.g., Robert R. Keatinge, *The Single-Member LLC: Operating Agreement*

B. General Partnership

In some respects the general partnership is not a "planned" entity because it often arises in very informal circumstances or situations where the participants are unaware of the type of legal relationship that they share. One of the general partnership's principal drawbacks, unlimited liability, has been addressed to varying degrees, but not completely, by LLP amendments.⁸⁴ Significantly, the LLP form is not available to those participants who fall into a partnership with a handshake deal; limited liability requires registration.⁸⁵

Even if the limited liability weakness is adequately met by future amendments to partnership statutes, other aspects of the general partnership may be viewed as less than desirable. It is beyond the scope of this article to discuss all of the perceived failings of the partnership, so our treatment will be brief.⁸⁶ First, due to the apparent authority that each partner wields, it is more difficult to constrain the activities of participants, although this has been addressed to some degree by RUPA in its concept of a statement of partnership authority.⁸⁷ Second, the ability of the partners to determine contractually the boundaries of their fiduciary duties to one another is less flexible than other entities, such as the LLC, particularly under RUPA.⁸⁸ Third, the partnership choice-of-law provisions are less predictable than those applicable to corporations or LLCs.⁸⁹ Fourth, the power (as opposed to the right) of

Questions and Other Issues, 3 J. LIMITED LIABILITY COMPANIES 87, 87-89 (1996); Larry E. Ribstein, *The Loneliest Number: The Unincorporated Limited Liability Sole Proprietorship*, J. ASSET PROTECTION, May-June 1996, at 46, 47-48.

84. Some of the LLP statutes provide protection by eliminating vicarious liability for the professional malpractice of co-partners, while others protect against both contract claims (e.g., trade creditors, landlords) and tort claims. See Keatinge et al., *supra* note 21, at 174-80. The interstate validity of the limited liability shield is potentially called into question in non-adopting states, of which there are now less than five, and those states in which the LLP legislation provides for more circumscribed protection. Some states permit only professionals to form LLPs. See, e.g., James L. Dam, *Should Clients Be LLCs or LLPs?*, LAW. WKLY. USA, July 15, 1996, at 1 (comparing state LLP statutes on a basis of whether the statute protects against both tort and contract claims). For a categorization of states based on the level of protection provided by their LLP statutes, see Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 22-24 (1997).

85. See, e.g., COLO. REV. STAT. § 7-60-144 (Supp. 1996) (stating LLP registration requirements).

86. For an appraisal of the shortcomings of the LLP, see Larry E. Ribstein, *Possible Futures for Unincorporated Firms*, 64 U. CIN. L. REV. 319, 327-40 (1996).

87. See REVISED UNIF. PARTNERSHIP ACT (RUPA) § 303, 6 U.L.A. 39 (1995).

88. For some of the scholarly literature debating the fiduciary duty and other aspects of the revised partnership Act, see J. Dennis Hynes, *Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract*, 58 LAW & CONTEMP. PROBS. 29 (1995); Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45 (1993); Allan W. Vestal, *Advancing the Search for Compromise: A Response to Professor Hynes*, 58 LAW & CONTEMP. PROBS. 55 (1995).

89. The revised Act states that the "law of the jurisdiction in which a partnership has its chief executive office governs relations among the partners and between the part-

partners to dissociate cannot be restrained.⁹⁰ Fifth, if comparisons are made with a single-shareholder corporation or a single-member LLC,⁹¹ the availability of a general partnership, with or without LLP provisions, is limited by the requirement of two or more partners.

Although the general partnership has its drawbacks, even a unified business entity proposal would not displace all partnerships because the general partnership is often a default vehicle for associates who do not appreciate the existence of that legal relation. There needs to be some default set of rules for these persons, and the general partnership serves that purpose. Accordingly, elimination of this form of organization would not be necessary, or desirable, for the adoption of a unified business organization statute.

A thought-provoking proposal is to give limited liability, by statute, to orally formed business associations (unregistered partnerships).⁹² As much as the legal system seems to favor limited liability for small business participants, this may be pushing the envelope a bit too far, even for its more zealous advocates. Yet why should registration be so crucial? If all partnerships were generally understood to have limited liability as a default rule, an argument based on the need for notice seems to be the question.⁹³ In that regard, based on federal

ners and the partnership." REVISED UNIF. PARTNERSHIP ACT (RUPA) § 106, 6 U.L.A. 25 (1995). The section comment states that the partners may agree to apply the law of another state, but that choice may not be respected if the partners or partnership do not have a substantial relationship to the state or if application of the chosen law would be contrary to a fundamental policy of a state which has a materially greater interest than the state of choice. *Id.* § 106 cmt., 6 U.L.A. 25. For a criticism of the provision, see Alan W. Vestal, *Choice of Law and the Fiduciary Duties of Partners Under the Revised Uniform Partnership Act*, 79 IOWA L. REV. 219 (1994).

90. See REVISED UNIF. PARTNERSHIP ACT (RUPA) § 103(b)(6), 6 U.L.A. 16-17 (stating that the "partnership agreement may not vary the power to dissociate as a partner").

91. Uncertainty concerning the income tax classification of one-member LLCs was eliminated by the check-the-box regulations, which permit an election to be treated as a corporation or as a non-entity, akin to a sole proprietorship with limited liability. See Treas. Reg. § 301.7701-2(c)(2) (1996).

92. Professor Ribstein has suggested that limited liability could be the default state of affairs. See Ribstein, *supra* note 82, at 474-75.

93. To be consistent, it would seem that limited liability, without registration, would also need to be extended to sole proprietors. At first blush, it would seem that a natural pressure point would be created—whether the person was acting in a business capacity (thereby entitled to immunity) or strictly in a personal matter. Cf. UNIF. PARTNERSHIP ACT (UPA) § 6(1), 6 U.L.A. 256 (1995) (partnerships must be formed for a business purpose); REVISED UNIF. PARTNERSHIP ACT (RUPA) § 202(a), 6 U.L.A. 27 (1995) (partnerships must be formed for a business purpose); REVISED MODEL BUS. CORP. ACT § 3.01(a) (providing that every corporation has the "purpose of engaging in any lawful business"); DEL. CODE ANN. tit. 8, § 101(b) (1991) (stating that a corporation may be incorporated or organized "to conduct or promote any lawful business or purposes").

With respect to tort actions, the distinction between personal and business affairs for an orally created business association could be largely irrelevant since the "sole proprietor" could be the sole actor, liable for any damages aside from entity considerations. However, with respect to contractual liabilities, the differences could be enormous.

One might argue that the same potential exists under the current system—it just

income tax return filing statistics, the number of sole proprietors who have not adopted a limited liability form of business remains very significant.⁹⁴

C. Limited Partnership

The limited partnership shares some of the drawbacks of the general partnership. Subject to the adoption of an LLP status for the general partner or the creation of a corporate general partner (with the added expense and complexity that entails) the limited partnership does not offer simple limited liability for all participants. In that regard, although the risk is minimal in states adopting the 1985 RULPA amendments, the limited partners are subject to some risk for personal liability if they participate in control of the partnership.⁹⁵ Ready dissolubility is still a problem with respect to the general partner, but that can be mitigated through the use of a corporate general partner and multiple general partners who have the power to continue the partnership. Apparently, the somewhat inflexible fiduciary duties of partnership law would apply to the general partner's dealings with the limited partnership.⁹⁶

The limited partnership does offer some advantages. First, limited partners are given voting and participation rights only on an opt-in

takes more paper. That is, one could contract for personal goods or services using a limited liability entity, like a corporation under the current system. Some impediments do exist to the personal use of a limited liability entity, such as the treatment of the contributions and expenditures under federal tax law and, as noted above, any state law requirements of a business purpose.

94. During 1993, there were 706,537 new business incorporations. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 551 (115th ed. 1995). In 1992, the number of federal income tax returns filed for businesses was: nonfarm sole proprietorships—15,495,000; partnerships—1,485,000 (this would include general and limited partnerships and LLCs); S corporations—1,785,000; and other corporations—2,084,000. *Id.* at 544.

95. The 1985 amendments to RULPA expanded the number of safe harbors for limited partner participation, including any "matters related to the business of the limited partnership not otherwise enumerated . . . which the partnership agreement states in writing may be subject to the approval or disapproval of limited partners." REVISED UNIF. LTD. PARTNERSHIP ACT (RULPA) § 303(b)(6)(ix), 6A U.L.A. 145 (1995). Language was also added to RULPA providing for limited partner liability "only to persons who . . . reasonably believe, based upon the limited partner's conduct, that the limited partner is a general partner." *Id.* § 303(a), 6A U.L.A. 144. In Colorado, a literal reading of the LLP amendments suggests that a limited partner could still be liable under section 303 of RULPA, even though the general partners have no liability. *Compare* COLO. REV. STAT. § 7-62-403(2) (Supp. 1996) (stating the liabilities of a general partner), *with id.* § 7-62-303(1) (1986) (explaining a limited partner's liability to third parties).

96. "Except as provided in this [Act] or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners." REVISED UNIF. LTD. PARTNERSHIP ACT (RULPA) § 403(a), 6A U.L.A. 177. "A general partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners . . ." UNIF. LTD. PARTNERSHIP ACT (ULPA) § 9(1), 6A U.L.A. 346 (1995).

basis;⁹⁷ they start with essentially nothing. This provides a clear-cut rule that scriveners and organizers can grasp. However, the entity is flexible in substantial degree, and the partnership agreement can delineate the types and manners of limited partner participation. Quick assumptions on the power of limited partners in any given organization, without careful reference to the partnership agreement, are more likely to be false than accurate. Second, unlike the corporation and perhaps the LLC, there apparently is no "piercing the veil" doctrine applied to limited partners. The area has been occupied by fixing liability for participating in control⁹⁸ and for incomplete registration. Third, some argue that an LLP has tax advantages in comparison with the LLC, in terms of wealth transfer tax valuation⁹⁹ and the self-employment tax.¹⁰⁰ Finally, some anomalies of state taxation create random preferences.¹⁰¹

Some knowledgeable practitioners wonder why anyone would use LLPs instead of LLCs in non-estate planning contexts when LLCs provide such a convenient, flexible alternative. The data on registrations may support their observation; limited partnership filings have declined somewhat recently while LLC filings have increased steadily.¹⁰²

97. REVISED UNIF. LTD. PARTNERSHIP ACT (RULPA) § 405, 6A U.L.A. 201.

98. See Gazur & Goff, *supra* note 6, at 402-03 (discussing "piercing" in the context of the limited partnership and LLC).

99. It is often observed that limited partnerships might provide better valuation discounts than similarly situated LLCs: "There are, however, situations where a limited partnership will continue to be more attractive—for example, limited partnership interests are more likely to qualify for significant valuation discounts under current gift and estate tax rules." Joseph B. Darby, III, *The Business Vehicle for the 21st Century*, HEMISPHERES, June 1996, at 37, 40. "Without any case law support and history, it seems reckless at best to trade known valuation treatment for speculative valuation treatment." D. John Thornton & Gregory A. Byron, *Valuation of Family Limited Partnership Interests*, 32 IDAHO L. REV. 345, 380 (1996). For a discussion of this issue, see *infra* Part III.E.

100. The distributive share of income of a "limited partner" is excluded from self-employment earnings. I.R.C. § 1402(a)(13) (1994). Status as a limited partner under state law presumably qualifies for the exclusion. With respect to LLCs, the IRS has proposed regulations which would treat an LLC member as a "limited partner" for purposes of the exclusion if: (1) the member is not a manager of the LLC; (2) the entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction; and (3) the member could have qualified as a limited partner in that limited partnership under applicable law. See Prop. Treas. Reg. § 1.1402(a)-18, 59 Fed. Reg. 67,253, 67,254 (1994). An IRS official has reportedly stated that the proposed regulation could be revamped to look at factors other than participation in management and to deal more broadly with the concept of "limited partner" in other contexts outside of LLCs, including business trusts. Joan Pryde, *IRS Looking to Revamp Regulations on Self-Employment Tax Treatment of LLCs*, 1996 Daily Tax Rep. (BNA) No. 109, at G-2, G-2 to G-3 (June 6, 1996).

101. In Florida, an LLC is subject to the corporate income tax, but a limited partnership is not. See FLA. STAT. ANN. §§ 608.471, 220.03(1)(e) (West 1993 & Supp. 1996). In Texas, an LLC is subject to the corporate franchise tax, while a limited partnership is not. See TEX. TAX CODE ANN. § 171.001(a)(2) (West 1992). In Pennsylvania, an LLC is taxed as a corporation unless a state S election is made or the "restricted professional company" exception applies. See 15 PA. CONS. STAT. ANN. §§ 8925(a), 8997(b) (West 1995).

102. As of October 4, 1996, there were 110,048 domestic Colorado for-profit corpo-

D. Limited Liability Company

The continuing revisions of the LLC led many to view the LLC as the form with the most promise. Because the LLC has been recognized in all fifty states, there is no longer any doubt that a foreign LLC will be recognized in any given state and that, under the internal affairs doctrine, place of formation law will be, for the most part, respected (aside from the reception of one-member LLCs in states which do not permit their formation). But most current versions of the LLC still have some problems, particularly when viewed in the check-the-box environment.

The LLC suffers from easy dissolubility,¹⁰³ an attribute which probably would not be desired by most organizers.¹⁰⁴ New versions of the statute will undoubtedly change this, as drafters originally designed the dissolution provisions to satisfy now obsolete federal tax rules.¹⁰⁵ In some states the members' power to define freely the scope of applicable fiduciary duties has been limited.¹⁰⁶ The change in the tax rules ought not to affect these provisions. In other states, notably Minnesota, the LLC legislation has been cluttered by corporate code

rations in good standing; 11,963 domestic limited partnerships; 420 limited liability limited partnerships; 1015 limited liability partnerships; and 19,433 domestic limited liability companies. Telephone interview with staff at the office of Victoria Buckley, Colorado Secretary of State (Oct. 4, 1996). The numbers demonstrate a dramatic increase in the number of LLCs and a slight increase in the number of LPs. In that regard, as of January 4, 1993 there were 1599 LLCs registered in Colorado. Tom Locke, *LLC Numbers Soar in State as Rules Eased*, DENV. BUS. J., Jan. 14, 1994, § 1, at 3. As of January 5, 1994, the number of LLCs had increased to 4388, and the number of limited partnerships stood at 10,514. *Id.* In Texas, on the other hand, the differences are not so dramatic. New incorporations decreased from 38,135 in 1995 to 35,474 in 1996. Robert Hamilton, *Limited Liability Companies and Partnerships* (posted Sept. 19, 1996) <<http://www.ljextra.com/maillinglists/lnet-llc/1464.html>>. New LLC filings increased from 5163 in 1995 to 5549 in 1996, while new limited partnership filings also increased from 6936 in 1995 to 7394 in 1996. *Id.* This surprising appetite for limited partnerships could be explained by the Texas franchise tax that is imposed on LLCs but not on limited partnerships. See TEX. TAX CODE ANN. § 171.001(a)(2).

103. To assure limited life for federal income tax classification purposes, most LLC statutes, as a default matter, provide for dissolution of the LLC upon classic partnership dissociative events like the death of a member. See, e.g., DEL. CODE ANN. tit. 6, § 18-801(4) (Supp. 1996) (dissolving an LLC upon the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member, unless the business of the LLC is continued by the consent of all the remaining members within 90 days following the event); COLO. REV. STAT. § 7-80-801(c) (Supp. 1996) (resembling the Delaware provision's language).

104. This is our assumption. Academics, however, view ready dissolubility as a desirable default result because it avoids the potential lock-in effect often associated with the closely held corporation. See *infra* text accompanying notes 209-11.

105. The National Conference of Commissioners on Uniform State Laws reportedly has proposed amendments to the Uniform Limited Liability Company Act that would eliminate the dissolution of the LLC upon a member's withdrawal. See *Estate Planning Alert!*, 4 LIMITED LIABILITY COMPANY REP. 501 (1996).

106. See Gazur, *supra* note 18, at 149-56 (discussing state LLC statute treatments of fiduciary duties).

detail.¹⁰⁷ A state-by-state critique of LLC law is beyond the scope of this article, but we address general guidelines in Part IV of this article.

To the extent that the LLC is underused, it is probably attributable to the reluctance of users and their lawyers to use the new legal entity, without a full file drawer of forms (operating agreements and organizational/constitutional documents).¹⁰⁸ If limited liability is available for more familiar entities, such as partnerships, limited partnerships, and S corporations, then why should they spend time learning the ropes on a novel entity? Especially since, to some degree, novelty implies that users will accept some risk until the law on LLCs matures.

E. Close Corporation

A close corporation, as formed by many organizers, is perhaps the simplest entity other than a "handshake" general partnership. The organizational documents are stylized, with a long pedigree, and well understood. In Colorado, for example, one can form a corporation with a one-page articles of incorporation supplied by the Secretary of State. That is not to say that these organizations are well-structured; the simplicity is obtained by overlooking or foregoing otherwise desirable documents like shareholder voting agreements, formal employment contracts, and agreements such as buy-sell arrangements, which provide some mechanisms for the orderly exit of shareholders. In addition to the low-cost simplicity of the close corporation, it also opens the door to S corporation status. In limited cases, organizers may prefer tax rules applicable to S corporations, rather than those governing partnerships, particularly in terms of avoiding self-employment taxes.¹⁰⁹ However, a recent IRS pronouncement, permitting an S corpo-

107. The Minnesota statute contains almost 150 sections and (with comments) occupies almost 200 pages of the *Minnesota Statutes Annotated*. See MINN. STAT. ANN. §§ 322B.01 to .960 (West 1995 & Supp. 1996).

108. See, e.g., Committee on Bankr. and Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 573 (1995) (explaining that lawyers do not use LLCs as Special Purpose Vehicles (SPVs) because they are unfamiliar with the structure).

109. The S corporation is generally considered less flexible than a partnership. Briefly, special allocations of items or income, gain, loss, deduction or credit are not permitted. I.R.C. § 1377 (1994). Unlike a partner, a shareholder does not increase personal basis for entity level debt. *Id.* § 1366(d). Even with recent liberalization, an S corporation cannot have more than 75 shareholders, more than one class of stock, or shareholders who are nonresident aliens. 26 U.S.C.S. § 1361(b) (Law. Co-op. 1996). On the benefits side of the ledger, the S corporation is not subject to the Internal Revenue Code § 704(c) rules that require allocations of pre-contribution gain or loss on the disposition of property by the partnership. I.R.C. § 1377. Also, losses on the worthlessness of S corporation stock are eligible for "ordinary loss" treatment. *Id.* § 1244. Furthermore, if public trading is desired or reorganization with another corporation under Internal Revenue Code § 368 is planned, the assets are already in corporate solution. Finally, and this is a big factor for some small business owners, S corporation undistributed profits or dividends

ration election by an LLC, has confirmed that a state law "corporation" is not the only avenue to S corporation status.¹¹⁰

While close corporation statutes attempt to permit close corporations to function like partnerships, the relationship is not fully contractual and vestiges of now largely obsolete mandatory prescriptions remain.¹¹¹ Interestingly, close corporation statutes are not updated and modernized with anything close to the zeal that identifies those concerned with the minutiae of general corporate codes.¹¹² This creates a system which does not work particularly well for anyone. On the one hand, several significant provisions are not intuitive for the unsophisticated organizer. The greatest surprises for those who use close corporation statutes without a careful evaluation of their provisions are those that lie in the provisions controlling the exit of dissatisfied participants. On the other hand, for the sophisticated organizers using general incorporation statutes, the courts will not always defer to their agreements, injecting uncertainty and opportunistic behavior into the business relationship.¹¹³ Arguably, a simpler, more forthright and flexible alternative is desirable.¹¹⁴

are not subject to Social Security and Medicare taxes. For a discussion of these aspects of the S corporation, see Gazur & Goff, *supra* note 6, at 454-57. See also Mark P. Altieri, *Considerations in Determining Whether to Elect S Corporation or LLC Status*, 27 TAX ADVISER 547, 548-52 (1996). The number of S corporation returns increased from 826,000 in 1986, to 1,785,000 in 1992, while the number of other corporate returns decreased from 2,603,000 in 1986, to 2,084,000 in 1992. BUREAU OF THE CENSUS, U.S. DEPT OF COMMERCE, *supra* note 94, at 547. This could reflect the desire for pass-through income tax treatment following the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085-963 (codified as amended in scattered sections of 26 U.S.C.). However, the number of partnership returns steadily declined from 1,703,000 in 1986, to 1,485,000 in 1992. BUREAU OF THE CENSUS, U.S. DEPT OF COMMERCE, *supra* note 94, at 547. This could be explained by the decline of the tax shelter industry following the Tax Reform Act of 1986. In that regard, the number of partnership returns reporting net income remained roughly constant over the period: 851,000 in 1986, and 856,000 in 1992. *Id.* Over the same periods, the number without net income decreased from 852,000 in 1986, to 629,000 in 1992. *Id.*

110. A recent private letter ruling suggests that taxpayers could be switching from S corporation "corporations" to LLCs treated as corporations to enjoy the greater state law flexibility of the latter entity. Priv. Ltr. Rul. 96-36-007 (Sept. 6, 1996). In this ruling, the S corporation reorganized into an LLC that had been structured to gain classification as a corporation, which in turn elected S corporation status, to avoid a tax on the liquidation of the corporation. *Id.*

111. Tara J. Wortman, *Unlocking Lock-In: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. REV. 1362, 1366-67 (1995). There is abundant scholarship discussing the apparent lack of enthusiasm for close corporation statutes in the relatively few states that have enacted separate statutory regimes or supplements. See, e.g., *id.* at 1362-65.

112. Delaware's general corporations law is now routinely fine-tuned with amendments every year. On the other hand, the Delaware Close Corporation Statute still requires that the corporation have no more than 30 shareholders. DEL. CODE ANN. tit. 8, § 342(a)(1) (1991). This would frustrate the 35-shareholder (now 75-shareholder) limit for S corporation status, presumably serving an important clientele. 26 U.S.C.S. § 1361(b) (Law. Co-op. 1996).

113. See Oesterle, *supra* note 11, at 910.

114. One commentator has predicted that the LLC, after check-the-box, will in-

F. Miscellaneous Entities

The above discussion is not exhaustive, and there are other entities with their proponents. Colorado, for example, has the limited partnership association that essentially operates as a close corporation statute for family estate planning purposes, responding to valuation drawbacks of the LLC and limited partnership.¹¹⁵ As of October 1, 1996, almost sixteen months after the effective date of the limited partnership association statute, only eighteen have been formed in Colorado.¹¹⁶

Delaware and, in turn, Wyoming have enacted statutory trust statutes that apparently are somewhat popular in creating passive investor units for asset-backed financings in a flexible environment with entity continuity of life.¹¹⁷ It is too early to predict the extent to which

creasingly displace corporations: "This [check-the-box] will very shortly cause LLC's to knock out corporations for closely-held businesses," says Stuart Levine of Baltimore, who chairs an ABA committee on the new regulations." Corey E. Fleming, *LLC's Get Enormous Boost*, LAW. WKLY. U.S.A., May 20, 1996, at 1.

115. For a discussion of the special wealth transfer tax valuation provisions of Chapter 14 of the Internal Revenue Code, see *infra* Part III.E.

116. Telephone interview with staff at the office of Victoria Buckley, Colorado Secretary of State (Oct. 3, 1996).

117. For a general discussion of these statutes, see Oesterle, *supra* note 11, at 914-17. A review (admittedly potentially misleading) of the names of over 1200 business trusts listed with the Delaware Secretary of State as of July 28, 1995, as well as references in the LEXIS and WESTLAW legal and news databases, suggests a lot of activity in asset-backed securities (including mortgages, loans, accounts receivable), asset leasing, and investment mutual funds. A presentation to the Business Law Section of the American Bar Association confirmed that the trust could be used for collateralized bond obligations, collateralized mortgage obligations, credit card and installment sale receivable trusts, royalty interest trusts, leveraged leasing arrangements, real estate investment trusts, and family-owned businesses. See James A. Florack & Martin I. Lubaroff, *The Best Entity for Doing the Deal*, in DELAWARE BUSINESS TRUSTS, at 371, 373 (PLI Corp. L. & Practice Course Handbook Series No. B4-7143, 1996). Speaking of the recently enacted Connecticut business trust statute, one commentator has noted that "[f]or large financings, a business trust makes a great deal of sense since it provides a set of rules that would otherwise have to be spelled out in participation agreements." Irving S. Schloss, *Limited Liability Companies and Partnerships* (posted Oct. 31, 1996) <<http://www.ljextra.com/maillinglists/lnet-llc/1652.html>>. The income classification of trusts is largely left unchanged by the check-the-box regulations. Fleming, *supra* note 114, at 1. Essentially, a trust will be taxed as a corporation if it has both associates and an objective to carry on a business for profit. See Treas. Reg. § 301.7701-4 (1996). Business trusts will often be taxed as corporations, but they often are in turn eligible for special tax regimes, applicable, for example, to real estate investment trusts and real estate mortgage investment conduits. See also Florack & Lubaroff, *supra*, at 387-89 (discussing possible treatment of a business trust as a grantor trust or as a partnership). A testamentary or inter vivos trust commonly encountered in estate administration usually will be excluded from corporation status for the lack of "associates" because the beneficiaries "do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement." *Id.* § 301.7701-4(a). Many trusts will also avoid corporation status for the lack of a profit objective because they protect and conserve the assets in a passive manner, rather than engaging in a business activity. Compare Rev. Rul. 79-77, 1979-1 C.B. 448 (classifying a trust holding a commercial building as a trust), with

the broadened Colorado cooperative statute will be utilized outside the traditional agricultural and commodity-based contexts.¹¹⁸

When one reaches the levels of specialization reflected in the miscellaneous statutes noted above, it is questionable whether a universal entity proposal can, or really should, seek to accommodate those clientele. It appears that while a universal entity can address the mainstream contexts, it cannot reach out beyond that.

III. THE CASE FOR A COMPREHENSIVE SMALL BUSINESS ENTITY STATUTE

Now that the federal income tax classification thumb is largely removed from the scale, it is time to rethink the fundamental structure of business associations seeking to distill the desirable aspects of the welter of existing entity choices. The outright repeal of other statutory business forms would not be a part of the proposal; practitioners and business organizers would need a transition period in any event, and if the new entity is ultimately better, the other forms should be driven into disuse. A cynic may label our recommendation as adding to the proliferation of forms. If history is any guide, this proposal is not the last word, but just another transitional step on an unpredictable path.¹¹⁹

Opponents of statutes similar to our proposal, occasionally labeled "unified entity" statutes, argue that they are not necessary and that no constituency, other than academics, will support their passage. However, we find it ironic that the same folks also take the position that current LLC statutes will eventually be amended to be more generic, more corporate-like.¹²⁰ Whatever the name, a more generic small busi-

Rev. Rul. 78-371, 1978-2 C.B. 344 (classifying a trust to develop real estate as a corporation). However, in an opinion in which the Tax Court took great pains to limit to its special facts, a testamentary trust lacking "associates" yet operating an active business barely avoided characterization as a corporation. *Estate of Bedell v. Commissioner*, 86 T.C. 1207, 1222 (1986), *acq. in result*, 1987-1 C.B. 1. If a trust is taxed as such, it is subject to a modified conduit treatment that taxes the beneficiaries on most distributions of income (subject, of course, to several exceptions) and taxes the trust on undistributed income. See I.R.C. §§ 641-683 (1994). Trust income tax treatment can be less desirable than pass-through treatment if income is accumulated in the trust because the trust and estate income tax rates are very compressed, with income in excess of \$7500 being subject to a 39.6% marginal income tax rate. See *id.* § 1(e) (the \$7500 statutory threshold is somewhat higher due to the application of an annual inflation adjustment).

118. For a discussion of the Colorado cooperative statute, see *supra* note 10.

119. The unpredictability in this area is startling. Even in 1990 there were few people who would have considered 50 states with LLC legislation by 1996 as a real possibility. The rapid development of tax law, ending with the check-the-box regulations, which essentially discard 40 years of partnership characterization law, is also stunning.

120. In a recent Internet symposium on the LLC, Professor Bernard Black, for example, observed that: "[T]here will be no political pressure to repeal old statutes—no one will care . . . [T]here will thus be costs to repeal and no benefits (none that a politician is likely to care about anyway—only us academics care about logic and symmetry and such)." Bernard Black, *Limited Liability Companies and Partnerships* (posted Sept. 12, 1996) <<http://www.ljextra.com/maillinglists/lnet-llc/1362.html>>. Professor Black later suggested that, "[i]f Congress retains the purely formal distinction between nonpublic enti-

ness form statute is needed without a preoccupation towards one section of the Internal Revenue Code.

The argument for a small business "limited liability entity" statute is set out in steps below.

A. Do We Need One Set of Default Rules or Several?

It is well-settled that any statutory regime creating and defining a business entity should, to the greatest degree possible, reflect a structure that would be the common denominator in the largest number of agreements by parties forming firms. This is assuming that those parties were left to their own devices to contract specifically to create a business form, without significant transaction costs. The degree of consensus in this admittedly hypothetical inquiry affects not only the number of sets of default rules needed, but the character of individual rules in any given set.

Measuring degrees of consensus among firms on issues of internal organizational structure will produce a continuum of results, which we have broken down into three major categories. On some matters there will be substantial agreement (Category One), other issues may have a scant majority in accord (Category Two). On other questions there may be little or no agreement (Category Three). In the simplest system, with one set of rules, rules on Category One matters are most likely to be mandatory¹²¹ or perhaps discretionary but difficult to amend.¹²² Rules on Category Two issues are most likely to represent the majority view, with those in dissent given license to modify them. Finally, Category Three questions are likely to be left entirely to the parties' specific agreement. In Category Three, default rules may exist but mainly to encourage the parties to elect specifically around them. Default rules in Category Three also serve to ease the judicial burden of formulating a term in individual cases when the parties themselves have an incomplete agreement.

The larger the number of rules in Category One and, to a lesser extent, Category Two, the lower the cost to the parties of forming a firm. Those who wish to contract around Category Three default rules and the dissenters to Category Two must expend the costs of contracting specifically for their own needs, incurring the drafting costs

ties that are called corporations, and those that are not, states will amend LLC laws to provide corporation law look-alikes." *Id.*

121. One could ask why Category One rules should not also be amendable by agreement if parties would not choose to do it very often. A response is that mandatory rules have significant "lock-in" benefits. They enhance the parties ex ante commitment to an agreed provision. Of course, "mandatory" rules in one statutory set, when several sets are available, are themselves discretionary because participants can elect an alternate system.

122. These conclusions are complicated by the fact that some rules are rules on amendment or change. A Category Two rule on substance could be supplemented by a Category One rule on ease of amendment. Unfortunately, this lively matter is beyond the scope of the paper.

and a higher potential for error since judges are more likely to misunderstand and misapply their basic agreement.¹²³

The creation of separate sets of rules is appropriate if the parties can be subgrouped so that, under two systems of rules instead of one, parties electing one form or the other increase the coverage of Categories One and Two and decrease Category Three. At this stage one could wonder, why not favor twenty or thirty sets of rules? We could minimize Category Three drafting costs by creating legal entities for any substantial subgroup not perfectly, or near perfectly, served by the existing rules.¹²⁴ The answer is, of course, that there are costs to adding multiple entities.

There are political costs of convincing a state legislature to adopt each new entity (which, perhaps, could be diminished somewhat by state competition for optimal systems); there are costs in regulatory confusion (governments must work each entity into a plethora of regulatory systems); and there are costs in application as lawyers and clients struggle to assess accurately and apply the correct form. A multiplication of forms would have the odd effect of undoing the nineteenth century move by states from individual incorporation to incorporation provisions for industries (utilities, bridges, etc.) to general incorporation statutes.¹²⁵ The same reasons that led states to move from industry-specific incorporation statutes to general incorporation statutes should retard the multiplication of small business forms.

An understated cost of our present system, which has at one time had a multiplicity of forms, and forms that are malleable enough to allow users to replicate one form within another, is the confusion and correlative opportunity for fraud effected on passive or minority investors who join small enterprises, often without legal counsel. There is no longer a basic meaning to the titles of businesses. A general partnership gave more rights ("protections") than a "close" corporation, which gave more rights than a corporation. Now, what rights in this queue does a "company" or a "partnership association" provide? Ask a lawyer.¹²⁶

Moreover, even given a lawyer's general understanding, each entity can be individually modified to negate that understanding. Any organization, taking full advantage of liberalizing opt-out rules, can produce a considerable surprise for passive or minority investors who do

123. Courts may not understand or simply refuse to enforce their agreement.

124. This is not the "Chinese Menu" approach, in which one can select from a vast universe of alternate separate provisions, criticized by Professor Ribstein. See Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 381-82 (1995). The difference being that, although there would be numerous entity alternatives, each would represent a coherent system.

125. See Dale A. Oesterle, *Formative Contributions to American Corporate Law by the Massachusetts Supreme Judicial Court from 1806 to 1810*, in *THE HISTORY OF THE LAW IN MASSACHUSETTS: THE SUPREME JUDICIAL COURT 1692-1992*, 127 (Russell Osgood ed., 1992) (discussing early corporations in New England).

126. The lawyer should be a specialist.

not get advice on the particulars of the entity in which they are investing. Hire a lawyer. If it is possible, we ought to minimize this element of surprise.

Applying the theory to practice, most would agree that we could, and largely do (although not with precision), group parties in publicly-traded firms separately from parties in privately-held firms, specifying structural systems for each that are materially different. Publicly-traded firms must deal with substantial agency cost problems associated with capital accumulation from large pools of passive investors. Privately-held firms do not.¹²⁷

However, the topic of the article is new non-corporate forms, and privately-held firms are the dominant users of such forms. At issue is whether additional division is appropriate in the subgrouping of privately-held firms. Can we get by with one "unified" unincorporated business statute? Or do we need three or four or more sets of rules? The new explosion in small business entities seems, at first glance, to demand an affirmative answer to the latter question.

A single comprehensive form could either be too constraining (one size does *not* fit all) or too flexible and vacuous so as to be devoid of guidance, particularly for small businesses that will rely upon default rules rather than elaborate written agreements. Professor Ribstein, for example, has argued that an extremely flexible, so-called "Chinese Menu" statutory approach, permitting organizers to choose from numerous alternate provisions,¹²⁸ is undesirable because the disparate provisions may not form a coherent set of terms.¹²⁹

But, as we have suggested earlier, the strength of the demand for a multiplicity of entities is easy to overestimate. Much of the need for separate entities rests solely on titles, not the essence of the rules within each system.¹³⁰ Perhaps all we need in our "unified" statute is an election on title. Consider a provision that enables anyone registered under a single statute to elect any of the following entity titles: corporation, company, or partnership. Such a provision may solve our liquor licensing problem.¹³¹ Another method of achieving the same result, of course, is to have three or four separate statutes with largely identical rules but different titles for businesses registered under each

127. For an argument that the division between publicly traded and privately held companies is a more rational place to divide those firms that may choose flow-through tax status from those that may not, see Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79 (1997).

128. See Ribstein, *supra* note 124, at 381.

129. We believe that subgroupings of default rules, as per our proposal below, answers his objection. See *infra* Part III.B.

130. For a discussion of factors related to title, and not organizational structure, that influence choice of entity form, see *supra* Part I.B.2.

131. For a discussion of conflicts between liquor licensing laws and choice of business entity titles, see *supra* notes 52-62 and accompanying text.

statute. Evidence for this argument, although admittedly weak,¹³² comes from the movement of modern codes for LLCs, corporations, and partnerships; these codes are gravitating toward each other in substantial respects and that trend should accelerate in a check-the-box environment.

In any event, history suggests that we could minimize Category Three¹³³ with several sets of rules for small businesses. The next issue is how the several sets should be organized and presented within any given state.

B. Methods of Presenting Alternative Sets of Default Rules

Most states have seven to nine separate entity statutes that the organizers of a small business ought to consider,¹³⁴ as we have here in Colorado, with some of the statutes borrowing from each other by express or implied incorporation by reference.¹³⁵ Pennsylvania is considering a bold new system in which some rules, the "hub," apply to all entities otherwise individually defined, the "spokes."¹³⁶ There are seven spokes.¹³⁷ Decisions on which rules go in the hub and which rules go in the spokes are critical and difficult. Pennsylvania, for example, has definitions of fiduciary duty (both the duty of care and loyalty),¹³⁸ permissible indemnification,¹³⁹ and mergers in which equity participants lose limited liability protections, in the hub.¹⁴⁰ Which system is optimal?

Some readers may wonder at this point what all the fuss is about. The previous section's question of how many sets of default rules are optimal is significant and weighty, but the issue in this section is trivial. Why does it matter if we have four or five separate freestanding sets of default rules, the hub and spoke system, or something in be-

132. The alternative explanation for the movement is that we are changing our views of where the real differences among entities ought to lie. The evidence of gravitation is simply modernization.

133. For a discussion of the three categories for issues of organizational structure, see *supra* notes 121-24 and accompanying text.

134. For an example of entity choices in one state, see the Colorado statutes discussed *supra* notes 1-10 and accompanying text.

135. Limited partnership statutes, for example, borrow freely from general partnership statutes. See Larry E. Ribstein, *Linking Statutory Forms*, 58 LAW & CONTEMP. PROBS. 187, 187-200 (1995) (discussing linkages between statutory forms for general and limited partnerships). Professional corporation and close corporation statutes borrow from general corporation statutes.

136. For an explanation of the Pennsylvania "hub and spoke" organization, see *supra* note 30.

137. The "spokes" are for-profit corporations, not-for-profit corporations, general partnerships, limited partnerships, limited liability companies, professional associations, and business trusts. See S. 1506, 180th Leg., Reg. Sess. § 102 (listing and defining the entity titles included in the bill).

138. *Id.* § 311.

139. *Id.* §§ 341-348.

140. *Id.* §§ 381-382.

tween (our present system with its limited incorporation by reference)? It has been said—to diminish the significance of the inquiry—that this matter is just a “law professors’ issue.”¹⁴¹ Creating a “clean” structure may occupy the time of academics, but does not mean much to users.¹⁴²

There seem to be some practical advantages, however, in choosing one system over another. For example, in the Pennsylvania system, rules in the hub may be difficult to change over time. And, as we have seen, a system that relies on incorporation by reference always seems to leave something out, imposing substantial “policing” costs on users.¹⁴³ Finally, systems that rely on completely separate statutes, with titles carefully assigned to each statute, create legal abnormalities if other regulatory systems do not keep up, leaving the newest entity titles out of their classification systems.¹⁴⁴ However, how the practical advantages balance out is, at present, anybody’s guess.

Our guess is detailed in Part IV. The essence of the proposal is a single entity structure with three packages of default rules. Participants are asked to elect one of the three packages or craft their own. Each package is consistent with a defining philosophy. We offer this structure based on two advantages over either the hub and spoke or the freestanding system. First, we hope that it will minimize problems with title in collateral regulatory systems. Each of the three options is titled an “entity” and registered as an entity with state officials. Second, we hope that it will minimize the confusion of parties who are not legally sophisticated, and in doing so, it will also minimize the opportunities for deceit. With partnerships looking like corporations, and some corporations looking like partnerships, and “companies” no longer a synonym for a corporation, an investor who invests in a “partnership” or a “company” or even a “corporation” can no longer rely on an intuitive sense of what rights go with the name. By asking promoters to choose among default rule packages and requiring an accurate disclosure of which package has been chosen, perhaps we can return some degree of accuracy to a more intuitive view of unincorporated associations.

C. *Isolating Non-Tax Threads in the Current New Entity Movement*

With the admitted accuracy of reading tea leaves, we need to attempt to filter the tax from the non-tax influences in the new entity

141. See Black, *supra* note 120.

142. *Id.*

143. See, e.g., Hill v. Behrmann, 911 P.2d 679, 682-83 (Colo. Ct. App. 1995) (holding that rules on corporations apply to mutual ditch companies formed under the turn of the century Ditch Act; the companies were forgotten in the current revision of Colorado corporate code), *cert. granted*, 911 P.2d 679 (Colo. 1996). See generally Ribstein, *supra* note 135 (discussing unanswered issues raised by the linking of the general and limited partnership acts).

144. For a discussion of some of the problems created by gaps in regulatory statutes, see *supra* text accompanying notes 52-72.

movement. We find, with large room for disagreement on several of the points, the following. Most, if not all, organizers of small business entities want limited liability¹⁴⁵ in whatever entity they choose. Most organizers do not want whatever entity they choose to dissolve automatically on the death or incapacity of a manager or investor.¹⁴⁶ And most organizers want prohibitions on theft of entity assets by insiders. Theft is defined to include, in addition to unauthorized taking of entity assets for personal use: first, sweetheart transactions between the entity and insiders (conflict of interest transactions); second, the usurping of entity business opportunities for personal gain; and, third, the waste of entity assets through disproportionate and excessive grants of salary and perquisites or on favored personal causes. Admittedly, the agony is in the details; much of the discourse in partnership, corporate, and LLC law is aimed at delineating the boundaries of "theft." Finally, most organizers want to give individual investors some recourse against managers for reprehensibly poor performance (reckless or intentionally inept performance), other than by a vote for ouster.

Beyond these three primary principles, organizers' desires seem to divide into major groups. We suggest the following subgroupings as most appropriate, recognizing that other subgrouping can be argued with equal force. In Group One, all equity investors, usually a small number, are active participants in the business. In Group Two, some of the equity investors are passive and the passive investors expect some substantial additional protections from majority control of the business by insiders. In Group Three, a substantial number of the equity investors are passive and, as sophisticated passive investors, do not want or need protections from majority control in addition to the basic rules against theft and reckless performance and their ability to demand firm-specific covenants.

Investors in Group One want management rights and protections from exclusion from management without cause; those in Groups Two and Three want some say in the selection of managers. Investors in Group Two also want some form of exit right (either automatic or contingent) or outside intervention (judge or arbitrator) in cases of majority oppression. Organizers in Group Three have the greatest latitude in fashioning their own internal structure. The structure for each group is fleshed out in Part IV below.

The evidence for the need for Group One comes from the popularity of partnerships and now limited liability partnerships, in which the

145. When tax characterization was an issue, however, the absence of limited liability was one factor weighing in favor of partnership characterization. See Treas. Reg. § 301.7701-2(a) (as amended in 1993) (replaced 1996) (listing six characteristics, including limited liability, considered when deciding whether an entity is a corporation for tax purposes). Under the check-the-box regulations, limited liability is no longer a factor in entity classification.

146. Many law professors would disagree. They see ready dissolubility as healthy because it helps, or at least forces the parties to reckon with, the potential lock-in of minority investors in the closely held corporation. See *infra* note 210.

default rule is for all partners to have management power. The model is of two friends, or perhaps family members, who go into business together. The evidence for the need for Group Two is from oddly disparate sources. Some evidence comes from the organization of modern high-tech enterprises in which venture capital firms commonly demand, in exchange for their contributions, a put option exercisable in five years. Other evidence comes from those who, as friends, contribute to a family business and who expect, and may be dismayed to find to the contrary, that exit is an option on some terms if the relationship sours. Evidence for the need for Group Three comes from the latest statutes in the LLC movement and RUPA. The new statutes are increasingly open-ended, leaving the parties to contract for minimal judicial interference in their businesses.¹⁴⁷ Here, the norm is an organization with passive investors who are sophisticated business people.

D. The Case for a Small Business Entity Statute

Putting the thoughts in subsection C together with those in subsection B, we conclude that one small business entity statute with three sets of default rules would be worth a try. All entities would be labeled and registered as "limited liability entities," avoiding the current problem with titles. We would prefer to call Group One organizations "limited liability partnerships," Group Two organizations "close companies," and Group Three organizations "private corporations." However, our use of the terms could resuscitate the current obsession with title in collateral regulatory systems. Our use of the term corporation, for example, would require corporate taxation characterization under the check-the-box rules.¹⁴⁸ Other titles are required.

Organizers of a limited liability entity would be required to select among the three sets of rules and notify all investors at the time of their investments of the set chosen. Limits are needed on decisions to move from one set of rules to another. For example, moving from one set of rules to another (by amending the constitutional documents or by merger) would require an investor vote of all participants if the organization started as a Group One type, of all minority participants if the organization started as a Group Two type, and a majority of all investors if the organization started as a Group Three type. Again, some of the details of this arrangement are fleshed out later in Part IV of this article.

147. The highly flexible LLC adopted in some states is the leading example of free contracting legislation. See Oesterle, *supra* note 11, at 900-14.

148. Under the check-the-box rules, companies organized under state "corporation" statutes or statutes that refer to the entities as "corporations" are treated as corporations for federal income tax purposes; the entities cannot elect to be treated otherwise (except for the S corporation election as a separate matter). See *supra* note 76. For an argument that privately held corporations may eventually be allowed to "check the box" as well, see Booth, *supra* note 127, at 78, 86.

E. Nagging Residual Tax Issues: Estate Tax Planning

Unfortunately, the check-the-box regulations for federal income tax classification do not eliminate the role of taxation in dictating the structure of small business entities. In some cases, our effort to rename small business entities as "limited liability entities" may help; in others, it may not. The zaniest example comes from the federal wealth transfer tax.

Since its enactment in 1990, estate planners have been fixated on mitigating the impact of the special wealth transfer tax valuation provisions of Chapter 14 of Subtitle B of the Internal Revenue Code (Chapter 14).¹⁴⁹ The four Internal Revenue Code sections¹⁵⁰ contained in Chapter 14 have produced a level of complexity and agonizing practitioner speculation with few rivals.¹⁵¹

Some of the anxieties experienced by practitioners about the potential application of Chapter 14 to their estate planning vehicles apparently prompted some to contact their state legislators. The legislators responded with changes to familiar entities, like the limited partnership, and the creation of new entities, like the limited partnership association, all designed to facilitate estate tax planning. If it could be said that state legislatures demonstrated little concern for the preservation of the federal income tax revenue base in quickly embrac-

149. Pub. L. No. 101-508, 104 Stat. 1388-491 (codified at I.R.C. §§ 2701-2704 (1994)).

150. See I.R.C. §§ 2701-2704 (1994).

151. See, e.g., Jerald David August, *Artificial Valuation of Closely Held Interests: Sec. 2704*, 22 EST. PLAN. 339 (1995); Martin D. Begleiter, *Estate Planning in the Nineties: Friday the Thirteenth, Chapter 14: Jason Goes to Washington—Part I*, 81 KY. L.J. 535 (1992-1993); Peter A. Borrok, *Four Estate Planning Devices to Get Excited About*, N.Y. ST. B.J., Jan. 1995, at 32; Kenneth P. Brier & Joseph B. Darby, III, *Family Limited Partnerships: Decanting Family Investment Assets into New Bottles*, 49 TAX LAW. 127 (1995); Bryan M. Dench, *Business Valuation Tax Freezes After OBRA 1990*, 7 ME. B.J. 238 (1992); Charles S. Grobe, *The Family Discount Partnership Tax and Non Tax Advantages*, 28 BEVERLY HILLS B. ASS'N J. 58 (1994); James R. Hamill, *Personal Residence Trusts Can Reduce Transfer Taxes*, 55 TAX'N FOR ACCT. 73 (1995); Louis S. Harrison, *Special Valuation Rules of Chapter 14 and Partnerships Can Save Transfer Taxes*, 11 J. PARTNERSHIP TAX'N 239 (1994); Louis S. Harrison, *The Real Implications of the New Transfer Tax Valuation Rules—Success or Failure?*, 47 TAX LAW. 885 (1994); Louis S. Harrison, *Using a Multi-Class Corporation to Achieve Estate and Gift Tax Savings: Does It Work After Chapter 14?*, 44 SYRACUSE L. REV. 1153 (1993); Terrance A. Kline, *Planning Opportunities with Family Limited Partnerships*, FLA. B.J., Mar. 1994, at 79; Louis A. Mezzullo, *New Estate Freeze Rules Replacing 2036(c) Expand Planning Potential*, 74 J. TAX'N 4 (1991); Lloyd Leva Plaine & Pam H. Schneider, *Prop. Regs. on Valuing Rights and Restrictions Focus on Exceptions*, 75 J. TAX'N 204 (1991); James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415 (1995); David S. Rhine, *Final Regs. on Chapter 14 Simplify Valuation Rules*, 21 TAX'N FOR LAW. 150 (1992); Nancy Shurtz, *Valuation Methods and Strategies Explained*, 22 EST. PLAN. 126 (1995); Mark R. Siegel, *The Internal Revenue Code's Assault on Buy-Sell Agreements*, 54 LA. L. REV. 149 (1993); Wayne L. Warnken & Pamela R. Champine, *Anti-Estate Freeze Rules Can Have Wide Scope*, 20 EST. PLAN. 220 (1993).

ing the pass-through LLC, one could repeat that charge with respect to the assault on the federal wealth transfer tax base.

In this section, we offer a simplified discussion of one subsection of Chapter 14, Internal Revenue Code § 2704(b), and its impact on the structure of limited partnerships and LLCs. We do not aim to educate estate planners, but to make the point that important distinctions in federal tax law ought not be tied to small business forms and titles. The rationale for the check-the-box regulations in the federal income tax code ought to be generalized in all tax law, and in particular to wealth transfer tax law. We have such a proposal at the conclusion of the section. But first, a discussion of the current mess.

The limited partnership and the LLC now play significant roles in estate planning. Both vehicles can offer limited liability to the participants¹⁵² and pass-through income tax treatment.¹⁵³ Aside from the practical benefits of providing a vehicle to carry family business or investment assets from generation to generation, including ordering the transition of family control of the entities and their underlying assets, the use of the limited partnership or LLC can also produce wealth transfer taxation benefits, principally in terms of the "valuation game."¹⁵⁴

Consider a client, age 65, with a net worth of \$5,000,000, much of which is represented by outright ownership of a family business, real estate, or publicly traded stocks. Charitable gift arrangements are of little interest. Continued lifetime gifts using the \$10,000 annual gift exclusion to shift present value and future appreciation,¹⁵⁵ life insurance, and other common estate reduction techniques do relatively little to deal with appreciation already earned. However, converting outright ownership of assets into other ownership structures can have an immediate depletion impact on valuation. Fractional interest discounts are perhaps the simplest. Suppose that the client gives one-third of his or her interest in Blackacre to the client's child. The client may argue that the gift is valued at less than one-third of the overall value of Blackacre. Moreover, upon the client's death, his or her estate may ar-

152. Of course, the general partner of a limited partnership would otherwise be subject to liability unless a corporate general partner is utilized. The LLLP responds to this issue by extending limited liability to the general partner. *See supra* notes 21-22 and accompanying text.

153. While the S corporation offers pass-through income tax treatment, I.R.C. § 1366 (1994), it is clumsy for estate planning because multiple classes of stock can differ only in voting rights, not with respect to dividend and liquidation rights and preferences. Treas. Reg. § 1.1361-1(i) (1992). Moreover, being subject to overall corporate taxation rules still limits the flexibility in moving assets to and from the corporation without income tax consequences. *See, e.g.*, I.R.C. § 311 (1994) (attributing gain to the corporation on non-liquidating distributions of property); *id.* § 336 (attributing gain to the corporation on liquidating distributions of property).

154. *See, e.g.*, Bryle M. Abbin, *Is Valuation the Best Planning Game Remaining?*, in *PLANNING TECHNIQUES FOR LARGE ESTATES* 739, 760-62 (ALI-ABA Course of Study, Apr. 22, 1996).

155. *See* I.R.C. § 2503(b).

gue that the value of the estate's interest in Blackacre is less than two-thirds of the overall value of Blackacre. Arguably, the value has evaporated.¹⁵⁶

In a related theme, if the client gives minority interests in a family corporation, it may be argued that the gifted shares may be discounted for their lack of marketability and for their lack of control over corporate matters (e.g., liquidation of the corporation, dividends policy).¹⁵⁷ However, if the client wants to claim a discount for publicly traded stocks,¹⁵⁸ wants to create a larger discount than the fractional interest discount doctrine would supply, or wants to create illiquidity or control discount possibilities beyond those provided by the extant organizational structure of the family business enterprise, a new entity may be required. Along those lines, the client would contribute the assets to a new "family" limited partnership or LLC.¹⁵⁹ Upon the gift of limited partnership or LLC interests to family members, or upon the death of the owner of such an interest, the donor or the estate of the decedent, as the case may be, will typically assert that the value of the

156. See, e.g., *Propstra v. United States*, 680 F.2d 1248, 1249-53 (9th Cir. 1982) (granting a 15% discount on real estate); *Estate of Pillsbury v. Commissioner*, 64 T.C.M. (CCH) 284 (1992) (same). But see Tech. Adv. Mem. 93-36-002 (May 28, 1993) (fractional interest discount should not exceed the costs of a partition action). Although beyond the scope of this article, the taxpayer must contend with IRS arguments that fractional discounts may be lost upon subsequent aggregation of the interests. See, e.g., *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996) (holding that § 2044 does not require QTIP assets to merge with other assets); Tech. Adv. Mem. 96-08-001 (Aug. 18, 1995) (holding that the decedent's partnership interests in the gross estate under § 2044 and § 2038 are to be aggregated); Tech. Adv. Mem. 95-50-002 (Aug. 31, 1995) (holding that stock in a closely held corporation that is included in the decedent's gross estate under § 2044 will be aggregated with stock owned outright by decedent); Tech. Adv. Mem. 91-40-002 (Oct. 4, 1991).

157. See, e.g., *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 249 (1990) (stating that it would be unreasonable to not apply a discount for a minority interest in a closely-held corporation), *nonacq.*, 1991-1 C.B. 1; *Ward v. Commissioner*, 87 T.C. 78, 109 (1986) (holding that discounts for lack of control and marketability are necessary).

158. With a publicly traded stock, lack of marketability would not generally be an issue, and the minority discount would be reflected in the market price. On the other hand, with large blocks of even publicly traded stock, the taxpayer could be subject to a control premium if practical control of the corporation is achieved, but he could claim a blockage discount if placing the shares in the market at one time would depress the market price. See Treas. Reg. § 20.2031-2(e) (as amended in 1992) (blockage discount rule). The use of family limited partnerships or LLCs to successfully reduce the estate taxation value of publicly traded stocks is subject to some uncertainty, including technical matters such as avoiding "investment company" treatment under I.R.C. § 351(e) and § 721(b). See Michael D. Mulligan, *Family Limited Partnerships*, COMPLEAT LAW., Summer 1996, at 29. One practitioner recently reported that a family limited partnership with 75% of the assets comprised of publicly traded securities claimed a 57% discount in the estate tax return which was settled at audit with a 40% discount. Lynn Fowler, *Limited Liability Companies and Partnerships* (posted Oct. 10, 1996) <<http://www.ljextra.com/maillinglists/lnet-llc/1568.html>>.

159. A corporate structure, in some respects, offers better valuation discounts, but it suffers from double taxation of income.

interest should be discounted substantially for lack of marketability, illiquidity, and a minority lack of voting control.¹⁶⁰

The valuation discount in large part is produced because the taxpayer has exchanged outright ownership of an asset for an interest in an entity that, while owning the asset, imposes more restrictions on access to the contributed asset's value. Marketability will usually suffer; while there may be ready buyers for a fee simple absolute interest in Blackacre, the same cannot be said for an interest in a family entity. Moreover, if the taxpayer owns only a minority interest in the entity, the taxpayer cannot control the timing of the distribution of profits generated from the underlying assets. Furthermore, the taxpayer cannot readily receive, through liquidation of the enterprise, a proportionate share of its net assets. The last two claims are subject, however, to the family's power to waive or otherwise amend the restrictive provisions whenever it suits their purposes. So the Internal Revenue Code, principally in § 2703¹⁶¹ and § 2704,¹⁶² ignores certain value-depressing restrictions imposed in the organizational documents of "family" limited partnerships or LLCs. The latter section is particularly pertinent to the fundamental structure of business association statutes.

Internal Revenue Code § 2704(b) provides that if a taxpayer transfers an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family,¹⁶³ and the transferor and members of the transferor's family hold control¹⁶⁴ of the entity immediately

160. This assumes, of course, that if the estate of the decedent is to qualify for a minority discount, lifetime gifts of interests to other family members would be required to dissipate the control position. The wealth transfer valuation of closely held business has been a popular topic, the details of which are beyond the scope of this article. See, e.g., John A. Bogdanski, *The Outer Limits of Minority Discounts*, 23 EST. PLAN. 380 (1996); Thornton & Byron, *supra* note 99; Andrew J. Willms, *Discounting Transfer Taxes with LLCs and Family Limited Partnerships*, 13 J. TAX'N OF INVESTMENTS 210 (1996).

161. This section disregards, for valuation purposes, buy-sell agreements and options to purchase unless (1) the agreement is a bona fide business arrangement; (2) the agreement is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and (3) the agreement's terms are comparable to similar arrangements entered into by persons in an arms' length transaction. I.R.C. § 2703(b).

162. This section contains two themes. Subsection (a) treats as a taxable event (a gift or an addition to a decedent's taxable estate, as the case may be) the lapse of "voting or liquidation rights" in a corporation or partnership. *Id.* § 2704. Subsection (b) ignores the effect of restrictions on the ability of a corporation or partnership to liquidate. *Id.*

163. "Member of the family" means an individual's spouse, any ancestor or lineal descendant of such individual or such individual's spouse (and any spouse of any individual so described), and any brother or sister of the individual (and any spouse of such brother or sister). *Id.* § 2704(c)(2). Interests held indirectly through a corporation, partnership, trust or other entity are treated as owned by the individual holding the interest. *Id.* § 2701(e)(3).

164. "Control" in the case of a corporation means the holding of at least 50% (by vote or value) of the stock of the corporation. See *id.* §§ 2704(c)(1), 2701(b)(2)(A). In the case of a partnership, "control" means the holding of at least 50% of the capital or profits interest in the partnership, or in the case of a limited partnership, the holding of any

before the transfer, any "applicable restriction" is disregarded in determining the value of the transferred interest.¹⁶⁵ An "applicable restriction" means any restriction which effectively limits the ability of the corporation or partnership to liquidate and either: (1) the restriction lapses in whole or in part after the transfer, or (2) the transferor or any member of the transferor's family, alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.¹⁶⁶ If the transferor and his or her family do not control the entity in question immediately prior to the transfer or if there is a right to remove the restriction, it is deemed not held by the transferor or related parties.¹⁶⁷ In the context of a family estate planning vehicle, where the absence of family control will often not be desirable from a practical standpoint,¹⁶⁸ the focus has shifted to avoiding characterization as an "applicable restriction."

The Treasury regulations state that an applicable restriction is "a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."¹⁶⁹ Consequently, one manner by which status as an "applicable restriction" apparently can be avoided is that the restriction be that generally provided by state law (i.e., the default provision under the relevant enabling statute).¹⁷⁰ Skirting § 2704(b) has produced a great deal of discussion,¹⁷¹ and the ultimate sweep of § 2704(b) is uncertain. Its apparent impact on limited partnerships and LLCs cannot

interest as a general partner. See *id.* §§ 2704(c)(1), 2701(b)(2)(B).

165. *Id.* § 2704(b).

166. *Id.* § 2704(b)(2). The term "applicable restriction" does not include any commercially reasonable restriction which arises as a part of any financing by the corporation or partnership with a person unrelated to the transferor, transferee, or a member of the family of either, nor does it include any restriction imposed, or required to be imposed, by any federal or state law. *Id.* § 2704(b)(3).

167. *Id.* § 2704(b)(2)(B)(ii).

168. In conversations with estate planning practitioners, the authors have found practitioners who do allow apparently unrelated parties (charitable organizations, one's accountant, etc.) to hold the power to block the liquidation of the entity or a transfer of interests. For a brief discussion of the perceived drawbacks to using charitable organizations and the potential for using lender-imposed restrictions and buy-sell agreements, see Patricia A. Templar & Douglas M. Cain, *FLPs for Family Asset Management and Transfer Tax Planning*, 24 COLO. LAW. 1245, 1251-52 (1995).

169. Treas. Reg. § 25.2704-2(b) (1992).

170. I.R.C. § 2704(b)(3)(B).

171. See, e.g., H. Bryan Ives, III, *Valuation Discounts for Partnership and LLC Member Interests*, 1 J. LIMITED LIABILITY COMPANIES 110, 111 (1994); Larry E. Ribstein, *Statutory and Planning Considerations for Withdrawal from an LLC*, 1 J. LIMITED LIABILITY COMPANIES 64, 69-70 (1994); Willms, *supra* note 160, at 215-16. One commentator has suggested that even participant class distinctions created under an LLC agreement (as contrasted with the prescribed limited and general partner classes of a limited partnership) "would be ignored by the application of Internal Revenue Code sections 2703 and 2704." Thornton & Byron, *supra* note 99, at 381.

be generalized; one must examine the relevant state statute, and Colorado's response to § 2704 is a good example.

Prior to 1995 amendments, the Colorado limited partnership statute followed the Revised Uniform Limited Partnership Act language which provided that, in the event the agreement was silent as to withdrawal, a limited partner could "withdraw upon not less than six months' prior written notice to each general partner."¹⁷² The potential § 2704(b) problem is readily apparent; the "restriction" generally applicable under state law is a right to withdraw and consequently receive the fair value of the partnership interest.¹⁷³ In 1995, the statute was amended to modify the default language to read as follows: "A limited partner may only withdraw from a limited partnership at the time or upon the happening of events specified in writing in the partnership agreement."¹⁷⁴ Arguably, the default position for the purposes of § 2704(b) is that, in the absence of provisions in the partnership agreement, a limited partner has no right to withdraw from the partnership at any time. A provision in the agreement permitting withdrawal on certain terms would appear to be less restrictive, rather than more restrictive, than the default provision and therefore should not constitute an "applicable restriction."

The Colorado LLC statute is a bit more confusing, reflecting the absence of the sharp general partner/limited partner distinctions found in the limited partnership statute. "Unless prohibited in a written operating agreement," a member may resign from an LLC at any time,

172. *Id.* The uniform Act states:

A limited partner may withdraw from a limited partnership at the time or upon the happening of events specified in writing in the partnership agreement. If the agreement does not specify in writing the time or the events upon the happening of which a limited partner may withdraw or a definite time for the dissolution and winding up of the limited partnership, a limited partner may withdraw upon not less than six months' prior written notice to each general partner at his [or her] address on the books of the limited partnership at its office in this State.

REVISED UNIF. LTD. PARTNERSHIP ACT (RULPA) § 603, 6A U.L.A. 217-18 (1995). The Colorado statute generally followed the language of the uniform Act, with some minor modifications concerning the notices to general partners. *See* COLO. REV. STAT. § 7-62-603 (1986). Note that the language is disjunctive, that the limited partner may withdraw only if there is neither a time or event specified for the withdrawal of a limited partner *nor* a definite time for the dissolution and winding up of the partnership. *Id.* The argument was made that if the certificate of limited partnership provided a specific period of existence, limited partner withdrawal was precluded *and* the set term was not an applicable restriction. *See* Ives, *supra* note 171, at 112-14. Whether the set term was required by statute (and consequently not an applicable restriction) turned upon whether the RULPA § 201(a)(4) certificate of limited partnership content was followed, requiring "the latest date upon which the limited partnership is to dissolve." *Id.* at 113.

173. REVISED UNIF. LTD. PARTNERSHIP ACT (RULPA) § 604, 6A U.L.A. 220. Upon withdrawal, the withdrawing partner is entitled to receive any distribution provided in the partnership agreement, and if not otherwise provided, the fair value of the limited partnership interest. *Id.*

174. COLO. REV. STAT. § 7-62-603 (Supp. 1996).

but if the resignation violates the operating agreement, the LLC may recover and offset damages.¹⁷⁵ It would seem that a restriction on withdrawal would constitute an "applicable restriction," assuming the other factors (like family control) are present.¹⁷⁶ On the other hand, resignation from a Colorado LLC is ultimately somewhat illusory, because although one accordingly loses the status of "member" with the attendant voting rights and other privileges, the resigning member is not entitled to the immediate return of the member's investment.¹⁷⁷

The marketability discount is enhanced by the structure of the limited partnership and LLC statutes that follow the "assignee" approach to transfers of partnership interests. For example, while limited partner interests are, as a default matter, "assignable in whole or in part"¹⁷⁸ the transferee remains only an assignee unless the partnership agreement authorizes the admission as a partner or all other partners consent to such admission.¹⁷⁹ The LLC statute follows a similar pattern.¹⁸⁰ The treatment of additional restrictions on transfers, such as first rights of refusal or bars on transfer, is beyond the scope of this article.¹⁸¹

The provisions on withdrawal from limited partnerships and LLCs are not the primary concern of § 2704(b), however. Recall that an applicable restriction looks to restrictions on liquidation of the entity. In that regard, the default rules for both the Colorado limited partnership and LLC are dissolution and winding up upon an estate tax pertinent event such as death.¹⁸² A limited partnership "is dissolved and its affairs shall be wound up" upon an event of withdrawal of a general partner, which includes his or her death, unless there is at least one

175. *Id.* § 7-80-602.

176. Upon the death of a member, the successor in interest has only the rights of an assignee. *Id.* § 7-80-704(1), (3). It would appear that a transferee is only "entitled to receive the share of profits or other compensation by way of income and the return of contributions to which that member would otherwise be entitled" and could not resign. *Id.* § 7-80-702(1).

177. *Id.* §§ 7-80-602 to -603.

178. *Id.* § 7-62-702 (1986).

179. *Id.* § 7-62-704.

180. *See id.* § 7-80-702 (Supp. 1996).

181. The Internal Revenue Code defines "applicable restrictions" in terms of limitations on the ability of the entity to liquidate. I.R.C. § 2704(b) (1994). A transfer restriction does not seem to be a restriction on liquidation, but since voting rights flow from admission as a member or partner, the ability to vote on or control liquidation is impacted indirectly. This section also permits the IRS to issue regulations that would disregard other restrictions that reduce the value of the transferred interest but do not ultimately reduce the value of the interest to the transferee. *Id.* § 2704(b)(4). Might this apply in some situations? Perhaps not; the Conference Committee Report in the general language introducing § 2704 states: "These rules do not affect minority discounts or other discounts available under present law." Omnibus Budget Reconciliation Act of 1990, H.R. CONF. REP. NO. 101-5835, at 1137 (1990). On the other hand, if the transfer restriction is a purchase option, Internal Revenue Code § 2703 could apply.

182. *See* COLO. REV. STAT. § 7-62-801 (1986) (stating when a limited partnership is dissolved); *id.* § 7-80-801 (Supp. 1996) (stating when an LLC is dissolved).

other general partner *and* the written provisions of the partnership agreement permit the business of the limited partnership to be carried on by the remaining general partner.¹⁸³ That would seem to constitute an “applicable restriction,” the saving grace being that dissolution is triggered only with respect to general partner events.¹⁸⁴ Similarly, a Colorado LLC is dissolved upon the death of any member unless the business is continued by the consent of all the remaining members.¹⁸⁵ If there is a written agreement in advance of an event of dissolution to continue the LLC or if the members eliminate death, for example, as an event of dissolution,¹⁸⁶ it would seem that this would constitute an “applicable restriction” that would be disregarded. Accordingly, a limited partner interest would apparently present a greater discount at death to the estate of the holder than an LLC interest because potential dissolution is not triggered by the death of a limited partner.¹⁸⁷

To address the perceived estate planning shortcomings of the limited partnership and LLC, the Colorado answer was the creation of a new entity. In 1995 Colorado adopted a new entity, the limited partnership association,¹⁸⁸ for which many of the § 2704(b) issues are limited. For example, under the default rules of the statute, an interest may be transferred only as provided in the bylaws, so the default rule is nontransferability.¹⁸⁹ If an absolute prohibition on alienation is permissible by law, then a strong discount for lack of marketability is certainly suggested. As a default matter, a member may not resign or withdraw.¹⁹⁰ With respect to the critical issue of dissolution and termination, the default provision is of “indefinite” duration.¹⁹¹ Recent statistics from the Colorado Secretary of State, reporting that only eighteen LPAs have been formed,¹⁹² suggest that Colorado practitioners are not comfortable with the LPA or are not convinced of its benefits.

In the aftermath of check-the-box and the inevitable delinking of the state law forms from the old income tax classification-driven norms, it would seem that the no-transfer, no-dissolution approach of the Colorado LPA statute will be appealing to users motivated by

183. *Id.* § 7-62-801 (Supp. 1996).

184. In structuring a family limited partnership, a corporate general partner or other entity is often used to practically limit the effects of death on the entity.

185. COLO. REV. STAT. § 7-80-801 (Supp. 1996).

186. The Colorado LLC statute is “flexible” and the operating agreement could provide that the LLC would not dissolve upon the occurrence of such statutory events. *See id.* § 7-80-108(3)(b).

187. *Id.* § 7-62-801. As stated in a recent comparison of entity choices in Colorado, “[t]hus, the discount for a [LLC] membership interest passing at death may be less than that applicable to a LP interest.” Robert R. Keatinge et al., *Choice of Entity in Colorado: An Update*, COLO. LAW., Oct. 1996, at 3, 46.

188. COLO. REV. STAT. §§ 7-63-101 to -117 (Supp. 1996).

189. *Id.* § 7-63-114(4).

190. *Id.*

191. *Id.* § 7-63-116(1).

192. Telephone Interview with staff at the office of Victoria Buckley, Colorado Secretary of State (Oct. 3, 1996).

transfer tax savings. It could be that other users would find perpetual life desirable, and perhaps would find the same to be true for transferability.

Beyond the immediate details of avoiding the sweep of the Chapter 14 valuation rules, one must question the narrow focus of Congress in the "applicable restriction" game and its emphasis on default rules. This exemption from § 2704(b) apparently reflects skepticism about the permanency of restrictions found in the organizational documents of businesses under family control. That is, even if a restriction appears in a document, thereby depressing the value of the entity interests at a relevant time, the restriction might be thereafter waived, modified, eliminated, or ignored because of the family relationship of the controlling owners.¹⁹³ While the base line of default provisions, prescribed by statute, at first blush is not susceptible to this type of manipulation, that is not true upon further consideration. The default provisions are manipulable by a change in the entity itself (e.g., limited partnership versus LLC) and by a change in the state of formation (e.g., LLC and limited partnership statutes vary from state to state with respect to key provisions). A family can accomplish these changes through a simple merger of the operating entity into a shell entity, newly formed for the purpose. Thus, if states follow the pattern of Colorado in manipulating the default rules for wealth transfer taxation advantage, § 2704(b) will become ineffective at preventing abuse of the minority discount valuation adjustment.

Although beyond the scope of this article, serious consideration should be given to modifying the federal estate transfer taxation rules themselves as the root of the problem. Because the revenue yield of the wealth transfer tax is modest in comparison with other federal taxes, and the transaction costs of planning for, complying with, and administering the tax may well exceed its yield, it is frequently asserted that the entire system should be repealed.¹⁹⁴ If the entire system is not to be scrapped, an abrupt departure from the present system's reliance on traditional valuation techniques would be amendments to Chapter 14 that eliminate, for valuation purposes, any entity-created discounts in family-controlled enterprises. A literal reading of § 2704(b) already suggests that result with respect to liquidation restrictions. Determining the boundaries of an "entity-created discount" would be difficult, however, and probably unworkable.

A less drastic approach, and one that could be administrable, would apply family attribution rules to the determination of control over the entity. That approach would reduce or potentially eliminate minority discounts and discounts based on transfer restrictions if the other interests in the entity were held in whole or in part by other

193. See I.R.C. § 2704(b) (1994).

194. See generally Wayne M. Gazur, *Congressional Diversions: Legislative Responses to the Estate Valuation Freeze*, 24 U.S.F. L. Rev. 95, 101-12 (1989) (discussing arguments for and against wealth transfer taxes and summarizing alternatives).

family members. The legislation would essentially reverse the result in *Estate of Bright v. United States*.¹⁹⁵ This approach was taken in the House Ways and Means Committee version of the Revenue Act of 1987, but was not included in the final legislation.¹⁹⁶

To save the discount but make it less dependent on firm form, another approach would be to penalize, in some fashion, subsequent waivers, amendments, or removals of the restrictions that gave rise to the earlier discount; this would address the alleged impermanence of family-controlled discount structures. This is the approach taken in Internal Revenue Code § 2701(d) with respect to unpaid distributions.¹⁹⁷ There are alternatives; the question is whether frustration with compliance costs, on the one hand, or revenue loss, on the other, will provide the impetus for change.

IV. OUTLINES OF A UNIFIED LIMITED LIABILITY ENTITY STATUTE

A. Introduction

Our recommendation for a Small Business Limited Liability Entity Statute has four parts. Part One is a core set of provisions on registration and limited liability that applies to all forms organized under the statute. In this respect, our proposal resembles the “hub” of the Pennsylvania entity proposal.¹⁹⁸ Parts Two through Four contain the provisions for each of three elective organizational structures. We lay out only the barest outlines of the statute to give readers an idea of how our proposal might work out in practice. Inherent in such a proposal, of course, is a plethora of choices on individual policy questions. We aim not to focus on such choices, although we make them, but on the general sense of our proposal.

The content of Part One, the core provisions, is minimal because, similar to the hub in the Pennsylvania statute, it promises to be the most difficult to amend. With respect to the elective proposals, we aim

195. 658 F.2d 999 (5th Cir. 1981). The IRS subsequently conceded the result of *Estate of Bright* in Revenue Ruling 93-12, 1993-1 C.B. 202.

196. See Gazur, *supra* note 194, at 120-22.

197. I.R.C. § 2701(d) (1994). Section 2701 values interests retained by the elder generation/donor in a family business structure. *Id.* § 2701. The statute was aimed at abuses in which taxpayers overstated the value of the retained interest (thereby understating the value of the subordinate interests gifted to family members). The statute ascribes no value to the retained interest unless it is a “qualified payment.” *Id.* § 2701(a)(3). If the dividend on corporate stock or other qualified payment on which the valuation was based is not in fact paid, § 2701(d) increases the donor’s gift or estate by roughly the amount of the payments in arrears. This is to be contrasted with § 2704(a) that creates a gift, or increases the taxpayer’s estate, by the amount by which a lapse of any voting or liquidation right otherwise *decreases* the value of the retained interest. This is the converse situation, aimed at the result in *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306 (1987).

198. For a brief explanation of the Pennsylvania “hub and spoke” organization, see *supra* notes 30, 136-40 and accompanying text.

to accomplish two objectives. First, we hope to eliminate the continuing external effects of the importance placed on titles by the system, which we have already discussed at some length.¹⁹⁹ Second, we hope that the elective proposals, formulated in a single unified context, provide a clearer choice than available under the current system, which is marked by a trend toward common provisions,²⁰⁰ on the one hand, and idiosyncratic, historical accidents, on the other.

B. Part One—Core Provisions

Registration of entities has three functions: it grants firms the power to sue and be sued as jural entities; it grants firms the power to offer investors limited liability on firm debts and obligations; and it supports state franchise fees. Part One contains the basic requirements for and effects of registration. Any individual can file with a named state official a request for certification as a limited liability entity. The filing need only contain a firm name, a designated office for service of process within the state, and an election to be treated as one of the three alternative forms. On receipt of the form by the designated state official, the entity's life begins and limited liability attaches to all the firm's investors. Housekeeping provisions would be required for routine matters such as appropriate names, the effect of defective registration and false claims of registration, and the power of the state to suspend registration and, absent a cure, to dissolve an entity on the failure of any entity to pay its annual fees.

The name of the entity, normally a mundane issue, requires some thought. It seems that if we are to free ourselves of the collateral consequences of titles, we do not want to use titles like "company" or "partnership." For the same reasons, and also to avoid per se check-the-box classification as a corporation, we should also avoid "corporation," "corp.," "incorporated," or "inc."²⁰¹ The inclusion of "Ltd." could be desirable to place third parties on notice of the potential limited liability aspects of the entity. However, that language could also create some confusion due to its inclusion as an available name in some cor-

199. For a discussion of the importance of titles in the current system, see *supra* Part I.B.2.

200. For example, the attribute of limited liability—once the great dividing line between corporations and other entities—has now been extended to all participants through the development of the LLC, LLP, and LLLP. With the check-the-box regulations, it is likely that the LLC statutes will be amended so that LLCs will no longer be subject to dissolution on account of member events, thereby more closely resembling the traditional corporation. Could a modification of the events of dissolution for limited partnerships be next? While further developments may be stunted by the arrival of the LLC as an alternative, the development of close corporation supplements has recently reflected a movement by corporations toward the more flexible, contractual approach. The new versions of the general partnership statutes are also liberalizing the parties' contractual powers.

201. For a discussion of classification as a corporation based on these descriptions, see *supra* note 76 and accompanying text.

porate²⁰² and limited partnership statutes.²⁰³ All things considered, we propose the name "limited liability entity" and its abbreviation, "LLE" or "L.L.E."

Organizers who like the designation of "partner" or "company" would need to look elsewhere. On the other hand, a member of a limited liability entity would be referred to as a "participant." We don't want to be title-driven ourselves, but "partner" is not appropriate; that term encompasses a separate body of law (which could wither under our proposal) that we do not want to confuse with our entity. "Shareholder" is an obvious corporate term that again could confuse the corporate body of law with ours, and we do not want to create any per se corporation concerns under the check-the-box system. We have not chosen "associate" because the term could suggest that one-participant entities could not be formed; it is our intention that our proposals would accommodate single participants.

There are some issues that should be coordinated for all of the alternatives, but on which we do not have a particular opinion. For example, should piercing the limited liability veil be addressed, linked to other standards like corporate doctrine, or mitigated? The Colorado LLC statute, for example, incorporates "the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law."²⁰⁴ In addition, it further provides that the failure to observe the formalities or requirements relating to the management of the business and affairs of the LLC is not in itself a ground for imposing personal liability.²⁰⁵ Should there be a penalty imposed at the entity level for wrongful distributions in addition to the penalties already provided by fraudulent conveyance statutes?²⁰⁶ And if so, what should be the standard?²⁰⁷ Finally,

202. See REVISED MODEL BUS. CORP. ACT § 4.01(a)(1) (1984); DEL. CODE ANN. tit. 8, § 102(a)(1) (Supp. 1996); COLO. REV. STAT. § 7-104-101(1)(a) (Supp. 1996).

203. See REVISED UNIF. LTD. PARTNERSHIP ACT (RULPA) § 102(1), 6A U.L.A. 67 (1995). RULPA states that the name of the limited partnership "shall contain without abbreviation the words 'limited partnership.'" *Id.* However, the Colorado adoption permits the use of "Ltd." standing alone. COLO. REV. STAT. § 7-62-102(1)(a) (1986).

204. COLO. REV. STAT. § 7-80-107(1) (Supp. 1996).

205. *Id.* § 7-80-107(2) (providing the same protection under uniform law); see also UNIF. LTD. LIAB. CO. ACT (ULLCA) § 303(b), 6A U.L.A. 454 (1995). Professor Ribstein has argued that such language is wrong-headed and that the better solution is to eliminate useless statutory formalities and to specify consequences for the failure to observe those that are retained. Larry E. Ribstein, *A Critique of the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 311, 348 (1995).

206. The drafters, including Professor Ribstein as reporter, of the Prototype Limited Liability Company Act rejected any limitations of this nature, relying on the general fraudulent conveyance laws of the applicable jurisdiction. PROTOTYPE LTD. LIAB. CO. ACT § 603 cmt. (1992).

207. RULPA's section 607 prohibits distributions if the liabilities of the limited partnership would exceed the fair value of the partnership assets. REVISED UNIF. LTD. PARTNERSHIP ACT (RULPA) § 607, 6A U.L.A. 225 (1995). The Delaware LLC statute, for example, prescribes a similar rule. See DEL. CODE ANN. tit. 6, § 18-607 (1993). The Revised Model Business Corporation Act, on the other hand, prescribes both an equity in-

a clear choice of law provision should be adopted, and we would adopt a corporate approach to the effect that the laws of the jurisdiction under which the entity is organized govern the entity and its internal affairs and the liability of its members.²⁰⁸

Under all of the alternatives, perpetual life is the default result; events occurring with respect to the members are not relevant. This should help with respect to wealth transfer taxation valuations,²⁰⁹ but that is not our purpose. We believe that perpetual life of the entity form would be desired by most organizers. Perpetual life has its problems—if a put or other exit right is not negotiated by the parties in advance, death can create hardship for the decedent's heirs who are otherwise locked into their investment.²¹⁰ We have provided for a put in the event of a member's death in Part Two, which would be used by the most closely held businesses without passive investors, but not in the other alternatives.²¹¹

solvency and bankruptcy insolvency rule. REVISED MODEL BUS. CORP. ACT § 6.40(c) (1984).

208. RUPA's choice of law provisions have been criticized as lacking certainty of result. *See Vestal, supra* note 89, at 243-56.

209. For a discussion of how nondissolubility upon a member's death enhances a discount for wealth transfer taxation purposes, see *supra* text accompanying notes 178-87.

210. Because the right to payoff may be costly for the members who wish to continue, many firms may choose to draft around it. The buyout right, however, is an appropriate default rule for the most closely-held firms, which often operate without a detailed agreement. The buyout right gives members some liquidity and thereby reduces the risk that a controlling faction will take advantage of a "frozen-in" minority.

Ribstein, *supra* note 171, at 66. ULLCA provides for put rights in an at-will LLC. UNIF. LTD. LIAB. CO. ACT (ULLCA) § 701, 6A U.L.A. 476-77 (1995). In that regard, the immediate put right under ULLCA is unavailable if the organizers opt for a set term, as opposed to an at-will LLC. *Id.* Dean Haynsworth and other members of the drafting committee believed that this would be a choice with obvious consequences, apparently even for the unsophisticated: "[T]he requirement that the specified term be stated in the articles of organization was deemed to be a simple but reasonable indication that the members understood the basic consequences of becoming a term LLC." Harry J. Haynsworth, *At-Will and Term LLCs Are Treated Differently Under Uniform Act*, 2 J. LIMITED LIABILITY COMPANIES 12, 17 (1995). Dean Haynsworth has defended ULLCA's inclusion of a member put in an at-will LLC as the default provision. The concern again was that "continuity similar to that which exists in a corporation, would . . . lead to the same kind of protracted, expensive, disruptive, and often inconclusive litigation involving close corporation shareholder claims of dissension, alleged squeeze outs, oppression, and frustration of reasonable expectations." *Id.* Professor Gevurtz concludes that LLC statutes should follow a limited partnership model and permit members to require that their interest be bought out by the company, unless otherwise agreed. *See Franklin A. Gevurtz, Squeeze-Outs and Freeze-Outs in Limited Liability Companies*, 73 WASH. U. L.Q. 497, 513-17 (1995). *See generally* Carter G. Bishop, *Treatment of Members Upon Their Death and Withdrawal from a Limited Liability Company: The Case for a Uniform Paradigm*, 25 STETSON L. REV. 255 (1995) (comparing ULLCA and existing state LLC statutes in terms of withdrawal remedies).

211. The absence of a put in the third alternative will support the creation of a liquidity discount for estate planning purposes, although the alternative is not particu-

C. Part Two—The Form for Group One: All Investors Are Active in Management

Part Two contains the structural rules for a firm that is characterized by an absence of passive equity investors. The typical business is owned and run by a small group of friends or family members. All equity investors are active in management. The rules are a modern adaptation of the rules of a general partnership. The closest modern analogy therefore, is the limited liability partnership.

Absent an agreement specifying executive offices (with attendant powers and responsibilities),²¹² all equity investors participate equally in the management of the firm. In that context, with no managers, the outlines of apparent authority would need to be addressed.²¹³ The default assumption is that all equity investors merit equal salary and all have contributed equally to the firm's capital. Thus, if any one investor receives a salary or other firm payment for management activities, absent an agreement, all investors must receive an equal amount. Similarly, any payments in return of capital must, absent an agreement, be made equally to all equity investors. The situation of a deceased member is problematic; the estate cannot practically work for a salary. Accordingly, we propose that, as a default matter subject to modification by the parties, a put should be prescribed on the occasion of the death or incapacity of a member.²¹⁴

Because of the close-knit management style of this option, it is likely that the members would wish to control membership, which directly impacts transferability. In a general corporate model, stock is freely alienable, although the shareholders can agree to impose restrictions.²¹⁵ In a partnership or LLC model, the financial interest of a partner or member can be freely alienable, but it requires the agreement of the other partners or members for the transferee's admission as a full partner or member.²¹⁶ For simplicity, we adopt the close corporate statute model because it deals with all of the interest, rather than bifurcating it. In that regard, restrictions along the line of sections 11

larly structured with that in mind.

212. This would be analogous to a corporate officer or the manager of an LLC.

213. We decline to adopt an express partnership rule that every participant is an agent of the entity. *But see* UNIF. PARTNERSHIP ACT (UPA) § 9, 6 U.L.A. 400 (1995); *id.* § 301, 6 U.L.A. 33. On the other hand, if managers were designated, it would be appropriate to statutorily delineate the boundaries of their authority.

214. *Cf.* MODEL STATUTORY CLOSE CORP. SUPP. §§ 14-17 (1984) (providing for a compulsory purchase right upon the death of a shareholder).

215. *See, e.g.*, REVISED MODEL BUS. CORP. ACT § 6.27 (1984) (describing shareholders' abilities to restrict the transfer of shares).

216. *See, e.g.*, UNIF. LTD. PARTNERSHIP ACT (ULPA) §§ 502-503, 6 U.L.A. 66-67 (1995) (stating a partner's ability to transfer interest and the transferee's resulting rights); UNIF. LTD. LIAB. CO. ACT (ULLCA) § 501-503, 6A U.L.A. 468-69 (1995) (stating the rights of a transferor and transferee of a distributional interest in a limited liability company).

and 12 of the *Model Statutory Close Corporation Supplement* could be appropriate, subject, of course, to the agreement of the parties.²¹⁷

Absent an agreement, a majority of the investors must agree to major firm decisions; any one investor can make choices in the normal course of business. Investors participating in management owe, at minimum, a duty of loyalty to the entity and a duty to refrain from any other intentional or reckless misconduct that causes injury to the entity. The parties can add additional duties by contract and further specify the content of the minimum duties. However, they cannot eliminate the duties altogether, although our last Form for Group Three would permit that. In this manner, within one proposal we have accommodated both views of this issue—one that already has produced a great deal of scholarly discourse.²¹⁸

A decision by a majority of the equity investors to exclude for cause any investor from management responsibilities gives the firm, absent an agreement, the continuing election to suspend payments for management activities, paying a risk-free rate of return on his or her capital account, or to force the excluded investor to leave on a payment of cash equal to his or her allocated share of the firm's assets, based on liquidation values and net of damages caused by his or her misconduct. Whatever the firm's election, the firm, as against the excluded investor, has any remedy provided by contract law for damages for additional injury to the firm. If the exclusion is without cause, the investor has a choice (non-waivable until *after* the decision to exclude is made or threatened) of all appropriate remedies supplied by the law of contracts for a material breach as well as a request that a court dissolve the firm.

Any decision to abandon this Form, through amendment, merger or otherwise, must be made by unanimous vote.

217. The *Model Statutory Close Corporation Supplement* generally provides that an interest in the shares of a corporation cannot be transferred except to the extent provided in the articles of incorporation. MODEL STATUTORY CLOSE CORP. SUPP. § 11. There are exceptions for transfers to other shareholders, members of the shareholder's family, unanimously approved transfers, transfers to one's estate, and pledges of stock as collateral. *Id.* § 11(b). However, the supplement permits a transfer of the shares, subject to a right of first refusal in favor of the corporation. *Id.* § 12.

218. See, e.g., Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 552-53 (1990) (offering the duty of loyalty as a "market mimicking" rule that everyone would want); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990) (stating the contractarian position); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1465-66, 1469-70 (1989) (arguing that participants cannot foresee the circumstances to which a waiver of duty would apply nor appreciate the risks); Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1601 (1989) (asserting that shareholders would not eliminate the duty of loyalty because it would license theft); Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 541 (1993) (discussing how the contractarian approach disadvantages unsophisticated participants, those without sufficient resources to engage counsel, and those without adequate experience to appreciate the problem).

D. Part Three—The Form for Group Two: Unsophisticated Passive Investors with Exit Rights

The second Form of small business limited liability entity assumes a small firm run by a majority of the equity investors as insiders, with a minority of the equity investors contributing capital and nothing else. This arrangement resembles a limited partnership or a statutory close corporation. The passive minority want special protections from opportunistic behavior by the insiders. The most important form of their protection is some form of an exit right.

All passive minority investors have a continuing right to put their interest back to the firm for cash equal to a proportionate share of the firm's value. The put right may, by contract, be limited to either vest three years or more from the minority investors' contribution or, again by contract, to be contingent upon misconduct by the majority—at minimum, breaches of their duty of loyalty to the firm or other intentional or reckless injury to the firm. In drafting the contingent put for misbehavior, we would again draw from the *Model Statutory Close Corporation Supplement*.²¹⁹ The parties would probably wish to control membership, so we would include, as a default matter subject to revision by the parties, transfer restrictions resembling those in the first Form.²²⁰

The majority insiders in such a firm have a duty to report annually to the passive investors, with the reports to include summary financials and a textual history of the year's business activities. They also have the traditional duty of loyalty and a streamlined duty of care against intentional or reckless behavior, enforceable through a participants' derivative action. Any decision to abandon this Form, by amendment, merger or otherwise, must receive a majority vote of the minority investors and will trigger put rights for dissenters.²²¹

E. Part Four—The Form for Group Three: Sophisticated Passive Investors

The third Form, designed for sophisticated parties, is completely open-ended. The organizers must prepare a written constitutional document that is, either in full or in summary form, made available to all

219. Referring to the *Model Statutory Close Corporation Supplement*, we would seek to define misconduct in terms of actions that are "illegal, oppressive, fraudulent, or unfairly prejudicial" toward the holder of the put. MODEL STATUTORY CLOSE CORP. SUPP. § 40(a)(1). The terms of the purchase of shares pursuant to the put could be crafted along the lines of another section of the supplement, calling for the determination of the fair value of the shares. *Id.* § 42.

220. For a discussion of transfer restrictions, see *supra* notes 215-17 and accompanying text.

221. Of course, with a true majority versus minority squeeze-out situation, a majority approval of salary agreements would not protect the minority, unless one wishes to exchange majority rule for rule by minority holdout. The put right for dissenters is the compromise.

equity investors at the time of their investments. The constitutional document specifies the complete organizational structure of the firm, including how the structure is amended. Investors may sue for breach of the document under traditional contract law theories or may sue for fraud or misrepresentation by organizers at the time of investment. The default rules could be provided by the state's general corporate code, if it is modern and lacks heavy and numerous mandatory provisions, which, with the exception of the corporate registration provisions, could be incorporated by reference or repeated in full.²²²

The Form is designed to be of use by a wide variety of sophisticated parties. Investment bankers can design Special Purpose Vehicles (SPVs)²²³ for structured financing; venture capitalists can design investment associations; and entrepreneurs of high-tech enterprises can design structures that accommodate venture capital. Finally, those looking for pass-through tax treatment, but in the context of a well-understood small corporate structure, can rely on the default rules in the Form.

CONCLUSION

With the traditional tax distinctions for small businesses eliminated, it would appear that, with the exception of the extension of limited liability to all participants, several of the newly minted small business entities have lost their underpinnings. Moreover, due to our preoccupation with simple titles in regulatory systems affecting firm operations, the newest amendments to the various registration statutes appear to be moving them inexorably closer together in substance, rather than offering entrepreneurs meaningful differences. This array of organizational alternatives is not without costs as practitioners, clients, and regulatory agencies struggle to master their nuances. We need to start from scratch.

Our recommendation consists of a Limited Liability Entity (LLE) statute that offers three alternatives to organizers that contain real operational differences. While our proposal is far from fully developed, and incorporates some controversial positions on individual issues, we hope that it will be part of a needed reappraisal of state laws for closely held business organizations in the check-the-box era.

222. This incorporation by reference to the corporate codes will hopefully not trigger per se corporate classification under the check-the-box regulations.

223. See Committee on Bankr. and Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., *supra* note 108 (discussing structured financing techniques, including uses of SPVs).