LIMITED LIABILITY COMPANIES AND VOLUNTARY CREDITORS: REEXAMINING THE ABOLISHMENT OF VEIL PIERCING

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I. INTRODUCTION

Piercing a company’s veil of limited liability remains one of the most litigated issues in corporate law and one of the most hotly debated topics among business-law scholars.1 Nonetheless, despite the numerous cases involving veil piercing, courts have hardly defined the...

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1. See, e.g., Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 CORNELL L. REV. 1036, 1036 (1991) ("Piercing the corporate veil is the most litigated issue in corporate law . . . .").
doctrine in a coherent or consistent manner. Further, this confusion is only enhanced when courts attempt to pierce the veil of a limited liability company (“LLC”).

The confusion surrounding LLC veil piercing stems from numerous factors, including some courts’ seemingly blind application of corporate standards, and worse, some courts’ misunderstanding that the corporation and the LLC are not the same entity. Indeed, the LLC is a different entity than the corporation in both structure and purpose. Most notably, the LLC is primarily a creature of contract, thereby making it a highly customizable business entity. Further, the contractual nature of the LLC is also ideal for voluntary creditors because, by default, many LLC statutes, such as the Delaware Limited Liability Company Act (“DLLCA”), provide voluntary creditors with numerous contractual avenues to ensure repayment. Moreover, there are other important doctrinal differences between the corporation and the LLC, such as those involving fiduciary duties. Nonetheless, courts ignore many of the LLC’s special features in veil-piercing cases.

This Article argues that courts and legislatures should prevent voluntary creditors from piercing the LLC veil. LLC statutes—including, most notably, the DLLCA—encourage freedom of contract, yet allowing voluntary creditors to pierce an LLC’s veil allows them to bargain for protection ex post. Moreover, the differences between the corporation’s and the LLC’s doctrines, structures, and purposes further support repeal. Section II of this Article provides the necessary background on veil piercing and LLC law. Next, Section III argues that LLC veil piercing for voluntary creditors is contradictory to both LLC statutes, such as the DLLCA, and LLC law in general. Section III also points out the important differences between the corporation and the LLC that should not be ignored by courts and legislatures. Finally, Section IV argues the difference in treatment for involuntary creditors is warranted and calls for courts to stop piercing the LLC veil for voluntary creditors.

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2. See, e.g., ROBERT CLARK, CORPORATE LAW 72 (1986) (“[T]he courts usually forgo any sustained attempt at a remedial theory or even a coherent exposition of the basis of liability, although descriptive summaries are occasionally attempted.”).

3. See infra note 94 and accompanying text.

4. See infra note 93 and accompanying text.
II. THE ENIGMA OF VEIL PIERCING AND THE LIMITED LIABILITY COMPANY

A. LIMITED LIABILITY AND ITS EXCEPTION

Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.5

—Judge Benjamin Cardozo

Entity separateness is a longstanding “bedrock principle”6 in business law.7 As a separate entity from its owners, an entity (such as the corporation or the LLC) has its own “legal rights, obligations, powers, and privileges different from those of the natural individuals who created it, who own it, or whom it employs.”8 Accordingly, an owner’s liability is limited to the amount of its investment in the enterprise.9 In other words, barring exceptional circumstances, the firm’s creditors cannot recover any unpaid business debts from the owners themselves.10 As a result, entity separateness encourages entrepreneurial activity by founders, risk-taking by management, and investment by passive investors.11 Not surprisingly, entity separateness—and its resulting limited liability—is the “the primary benefit” of the corporation and the LLC.12 Better stated, a firm’s “most precious characteristic” is the “privilege of limited liability.”13 In short, limited liability is “sacrosanct.”14

Nonetheless, like any privilege granted by the law, there is a risk of abuse or unfairness. Accordingly, there is an equally fundamental principle in business law that carves out an exception to limited liabil-

7. See Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518, 642-44 (1819); 1 William Blackstone, Commentaries on the Laws of England 455 (1797) (“[I]t has been found necessary . . . to constitute artificial persons, who may maintain a perpetual succession, and enjoy a kind of legal immortality. These artificial persons are called bodies politic, bodies corporate, . . . or corporations . . . .”).
10. See, e.g., United States v. Jon-T Chems., Inc., 769 F.2d 686, 690 (5th Cir. 1985) (“Creditors of the corporation have recourse only against the corporation itself, not against its parent company or shareholders.”); see also Revised Uniform Limited Liability Company Act § 304(a) (Unif. Law Comm’n 2006) (noting owners of an LLC are not liable for the debts and obligations incurred or torts committed by the LLC).
ity. Under the equitable doctrine of “piercing the veil,” a court may disregard a firm’s limited liability shield and hold the owners personally liable for the obligations of the firm. Piercing the veil is a logical and predictable complement to limited liability: who else would creditors seek payment from when a firm stops paying the bills?

Veil piercing has become more popular in recent years, and despite courts’ contentions that veil piercing is a “difficult task,” nearly fifty percent of veil-piercing claims are successful. Notwithstanding the numerous veil-piercing cases, courts have failed to identify a universal standard to apply. The confusion stemming from veil piercing is, undoubtedly, “the existence of incoherent and inconsistent multifactored tests.”

Nonetheless, as a starting point, courts generally pierce the veil if two requirements are met: first, there must be a unity of interest between the entity and its owner(s); and second, there must be a wrongful or fraudulent act by the owner(s), such that allowing the lack of separateness between the entity and its owner(s) to continue would promote fraud or injustice. Further, some courts also require a sufficient nexus between the abuse of the limited liability form and the alleged misconduct. That is, the owner’s wrongful conduct must be tied to the manipulation of the limited liability form to make veil piercing justifiable on grounds of equity.

To assist in their analyses, courts somewhat haphazardly apply numerous factors to determine if each requirement is met. Despite the myriad of factors enumerated by courts, the most persuasive factors for piercing the veil include injustice or unfairness, misrepresentations, and the owner’s fraudulent conduct. These factors are commonly known as the “multifactored tests” or “tests of separateness.”

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15. See Bestfoods, 524 U.S. at 62-63.
16. But see infra notes 33-37 and accompanying text.
17. See generally Stephen B. Presser, Piercing the Corporate Veil § 1.1 (2017) (explaining the doctrine’s basic principles).
18. See Jonathan Macey & Joshua Mitts, Finding Order in The Morass: The Three Real Justifications for Piercing the Corporate Veil, 100 CORNELL L. REV. 99, 105 (2014) (“Whenever a corporation is unable fully to meet its creditors’ demands for payment, . . . the company’s shareholders generally are the most attractive target.”).
21. See, e.g., Stephen M. Bainbridge, Abolishing Veil Piercing, 26 J. CORP. L. 479, 507 (2001) (noting the doctrinal standards of veil piercing are “often characterized by ambiguity, unpredictability, and even a seeming degree of randomness”).
22. Macey & Mitts, supra note 18, at 106.
tation or fraud, domination by a single owner, commingling of assets, and undercapitalization.\textsuperscript{26} It should be noted, however, that these factors are often applied inconsistently.\textsuperscript{27}

It is also worth noting some of the practical realities of veil piercing. First, courts will only pierce the veil of closely held entities because ownership in publicly held entities is too widely dispersed, which prevents adequate control of the firm to justify veil piercing.\textsuperscript{28} Second, veil piercing is more common when the entity is owned by individual shareholders or members rather than parent companies.\textsuperscript{29} Third, involuntary creditors are more successful than voluntary creditors in piercing the veil.\textsuperscript{30} Fourth, while the procedural components of veil-piercing claims are often misunderstood,\textsuperscript{31} “[i]nsolvency is a natural complement to veil-piercing,” as it would make little sense to seek recovery from a firm’s owners when the firm can satisfy the amount owed to its creditors.\textsuperscript{32} Fifth and finally, despite the fact that courts\textsuperscript{33} and commentators\textsuperscript{34} contend veil piercing is an equitable remedy, the doctrine does not appear to be rooted within concerns of inequitable bargains.\textsuperscript{35} Indeed, courts do not appear to sufficiently analyze the

\begin{enumerate}
\item[26.] See Oh, supra note 20, at 133 tbl.12, 134.
\item[27.] Compare Riggins v. Dixie Shoring Co., 592 So. 2d 1282, 1283 (La. 1992) (Dennis, J., concurring) (listing the failure to pay dividends as a factor for piercing the veil), with Soroof Trading Dev. Co. v. GE Fuel Cell Sys. LLC, 842 F. Supp. 2d 502, 521 (S.D.N.Y. 2012) (listing the payment of dividends as a factor for piercing the veil).
\item[28.] Oh, supra note 20, at 110, 110 tbl.3.
\item[29.] Id. at 110 tbl.4.
\item[30.] Id. at 141 tbl.14.
\item[31.] See Sam F. Halabi, Veil-Piercing’s Procedure, 67 Rutgers U. L. Rev. 1001, 1016 (2015) (“The reality is that veil-piercing claims run the gamut from freestanding causes of action . . . to affirmative defenses to, indeed, equitable remedies enforced at the end of litigation.”).
\item[32.] Oh, supra note 20, at 132.
\item[34.] See, e.g., Peter B. Oh, Veil-Piercing Unbound, 93 B.U. L. Rev. 89, 90 (2013) (“Veil-piercing is an equitable remedy.”); Thompson, supra note 1, at 1068.
\item[35.] See Oh, supra note 20, at 128 (noting there is “no appreciable difference in veil-piercing when a bargain involves only organizations, versus an organization with an individual”); see also Stephen M. Bainbridge, Abolishing LLC Veil Piercing, 2005 U. Ill. L. Rev. 77, 79 n.14 (2005).
\end{enumerate}
sophistication\textsuperscript{36} of the contracting parties in veil-piercing claims brought by voluntary creditors.\textsuperscript{37}

Not surprisingly, the inconsistent and sporadic application of veil piercing has prompted some commentators to seek reform and even abolishment of the doctrine.\textsuperscript{38} Others, however, have sought a simpler approach by attempting to clarify the doctrine. Specifically, commentators have argued the first prong of the veil-piercing analysis (i.e., lack of separateness) is merely a proxy for the actual reason courts pierce the veil.\textsuperscript{39} In fact, despite veil piercing’s purported confusion, commentators have established that courts will pierce the veil in predictable circumstances, such as to achieve the goals of a specific regulatory scheme, to avoid fraud or misrepresentation by owners attempting to obtain credit, or to promote bankruptcy values (i.e., resolving insolvency problems as efficiently as possible).\textsuperscript{40}

Avoidance of fraud or misrepresentation by owners is the most compelling justification identified, as fraud and misrepresentation are the most frequently cited rationales by courts for piercing the veil.\textsuperscript{41} Like most veil-piercing claims, this justification is classified based on the type of creditor. For voluntary creditors, courts may pierce the veil when there is evidence of misleading statements or representations that do not rise to the level of common law fraud.\textsuperscript{42} For involuntary creditors, courts may pierce the veil to discourage inadequate oversight or negligent mismanagement of a firm.\textsuperscript{43}

Additionally, piercing the veil to further a regulatory or statutory scheme is another compelling justification, as veil-piercing claims couched in violations of environmental statutes\textsuperscript{44} and employee bene-


\textsuperscript{37} Oh, supra note 20, at 129 tbl.10 (noting that veil-piercing contract claims are nearly equally successful between organizations and between individuals and organizations).

\textsuperscript{38} See generally Bainbridge, supra note 21 (calling for the total abolishment of the veil-piercing doctrine and discussing other reform attempts).

\textsuperscript{39} Macey & Mitts, supra note 18, at 102.

\textsuperscript{40} Id. at 113.

\textsuperscript{41} See Oh, supra note 20, at 133 tbl.12, 134.

\textsuperscript{42} Macey & Mitts, supra note 18, at 124-27.

\textsuperscript{43} See id. at 127-28.

\textsuperscript{44} See generally Lucia Ann Silecchia, Pinning the Blame & Piercing the Veil in the Mists of Metaphor: The Supreme Court’s New Standards for the CERCLA Liability of Parent Companies and a Proposal for Legislative Reform, 67 FORDHAM L. REV. 115 passim (1998); see also Cindy A. Schipani, Taking It Personally: Shareholder Liability for Corporate Environmental Hazards, 27 J. CORP. L. 29 passim (2001).
fits/Social Security statutes have a higher rate of success than veil-piercing claims that do not allege a statutory violation. Moreover, refusal to uphold a firm’s limited liability protections if doing so would directly undermine a statutory scheme that renders the firm’s conduct illegal is consistent with the other business law principles.

B. THE LIMITED LIABILITY COMPANY

For Shakespeare, it may have been the play, but for a Delaware limited liability company, the contract’s the thing.

—Chancellor William Chandler

The combination of the LLC’s increasing popularity for closely held businesses and the practical reality that courts will only pierce the veil of firms with few owners makes the issue of veil piercing in the LLC arena particularly important. The LLC’s unique characteristics are what make it different from the corporation. However, the LLC also imports fundamental aspects of corporate law, such as fiduciary duties and veil piercing (although to varying degrees).

1. LLC Basics

The LLC is a hybrid of the corporation and the partnership. It provides limited liability for its members and managers (like the corporation).
poration), freedom to structure its internal governance by agreement (like the partnership), and entity status (like both the corporation and the partnership). Further, while partnership law predominantly governs the LLC's internal governance, the LLC is "ideal for those wanting to craft a highly specialized and customized vehicle, specifying the duties and benefits among owners and managers."

The LLC's internal governance flexibility is by design. Indeed, in Delaware, "[i]t is the policy of [the DLLCA] to give the maximum effect to the principle of freedom of contract and to the enforceability of [LLC] agreements." For example, of the many contractual freedoms provided by the DLLCA, none evidence the LLC's flexibility more than section 18-1101(c), which allows management's fiduciary duties to be completely eliminated. Moreover, an LLC's operating agreement is not only malleable but very powerful too, as it is the firm's principle governing document. Consequently, this flexibility has made the LLC the entity of choice for many closely held businesses. And while the LLC has other notable characteristics, such as its

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53. See, e.g., Shawn J. Baye, Closely Held Organizations 244 (2014) (discussing the essential characteristics of LLCs and their similarities to corporations and partnerships).

54. See William T. Allen, Reiner Kraakman & Guhan Subramanian, Commentaries and Cases on the Law of Business Organization 68 (2012) ("[I]nternal relations among owners and investors in the LLC . . . is, for the most part, governed by general or limited partnership law.").


57. See infra Section III.A.

58. See Del. Code Ann. tit. 6, § 18-1101(c).

59. The terms "operating agreement" and "LLC agreement" are used interchangeably throughout this Article. Id. § 18-101(7).

60. See, e.g., Revised Uniform Limited Liability Company Act § 110(a) (Unif. Law Comm’n 2006) (giving the operating agreement primacy over the statute as to an LLC’s activities, the relations among its members, and the duties and rights over its managers); see also Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 290 (Del. 1999) ("[T]he LLC] permits members to engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of the [DLLCA]."); Fisk Ventures, LLC v. Segal, No. 3017-CC, 2008 WL 1961156, at *1 (Del. Ch. May 7, 2008) ("Contractual language defines the scope, structure, and personality of [LLCs]."); F. Hodge O’Neal & Robert B. Thompson, O’Neal and Thompson’s Close Corporations and LLC’s: Law and Practice § 5.3 (3d ed. 2017) ("[S]tatutes and courts defer to contracts of the LLC.").

61. See, e.g., O’Neal & Thompson, supra note 60, § 5.2 ("Overall the LLC statutes draw on both partnership antecedents and corporate law antecedents for an entity that has been mostly used by closely held businesses.").
check-the-box tax treatment, those features are not relevant for purposes of this Article.\(^{62}\)

2. LLC Fiduciary Duties

While partnership and contract law mainly govern the LLC’s internal affairs, corporate law still plays a significant role. Specifically, like corporate officers and directors,\(^{63}\) managers of an LLC owe the traditional fiduciary duties of care and loyalty to the firm’s members.\(^{64}\) In light of the LLC’s broad contractual customization, it should not come as a surprise, however, that some LLC statutes—particularly, the DLLCA—authorize fiduciary duties to be modified or eliminated in the operating agreement.\(^{65}\) Nonetheless, a summary of these duties is warranted for purposes of this Article and because waive fiduciary duties in LLCs is easier said than done.\(^{66}\)

First, the duty of care requires those making business decisions be adequately informed.\(^{67}\) This means the duty of care is not focused on the substance of the decision but on the decision-making process itself.\(^{68}\) Therefore, absent “gross negligence” by management in the decision-making process, a firm’s owners cannot sue management merely because a decision turned out poorly.\(^{69}\) If the plaintiff believes management did, in fact, act grossly negligent when making a business decision, the plaintiff must overcome the business judgment rule, which presumes management’s fiduciary duties are met when making

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\(^{63}\) See, e.g., Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).


\(^{65}\) See *DEL. CODE ANN.* tit. 6, § 18-1101(c).


\(^{68}\) See, e.g., JAMES D. COX & THOMAS L. HAZEN, *BUSINESS ORGANIZATIONS LAW* 200 (2016).

\(^{69}\) See Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000); Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985); Trenwick Am. Litig. Tr. v. Ernst & Young L.L.P., 906 A.2d 168, 173 (Del. Ch. 2006) (“What Delaware law does not do is to impose retroactive fiduciary obligations on directors simply because their chosen business strategy did not pan out.”).
business decisions. The business judgment rule is designed to prevent a court from imposing itself on a firm’s business and affairs; consequently, “[o]vercoming the presumptions of the business judgment rule on the merits is a near-Herculean task.”

Second, the duty of loyalty requires that management place the firm’s best interest over any interest management possesses that is not shared by the firm or its owners. Unlike the duty of care, the duty of loyalty is focused on management’s motives and purposes for a transaction rather than the decision-making process. The duty of loyalty is not limited to cases involving conflicted transactions, but also includes cases where management fails to act in good faith. Additionally, management breaches its duty to act in good faith by, not surprisingly, acting in bad faith, which includes either: (a) “fiduciary conduct motivated by an actual intent to do harm” (i.e., subjective bad faith); (b) “conscious disregard of one’s responsibilities” (i.e., intentional dereliction of duty); or (c) a know-
ing violation of the law, even where such a violation benefits the firm.\textsuperscript{79}

Finally, it is worth noting that although a firm has multiple constituencies with differing interests—such as owners, creditors, employees, and customers—the duties of care and loyalty are owed to the firm's owners, not its creditors.\textsuperscript{80} However, there is a dispute among jurisdictions and entity types as to whether creditors are owed fiduciary duties when a firm is in financial distress.\textsuperscript{81} Under Delaware corporate law, a corporation’s management never owes fiduciary duties directly to creditors,\textsuperscript{82} but creditors may bring derivative claims for breach of fiduciary duty upon insolvency because “creditors take the place of the shareholders as the residual beneficiaries of any increase in value.”\textsuperscript{83} While most jurisdictions have adopted the Delaware corporate law rule,\textsuperscript{84} others have not.\textsuperscript{85} Further, unlike Delaware corporate creditors, LLC creditors cannot bring derivative claims for breach of fiduciary duty even when the firm is insolvent.\textsuperscript{86}

\textsuperscript{79} See Miller v. Am. Tel. & Tel. Co., 507 F.2d 759, 762 (3d Cir. 1974); In re Walt Disney Co., 907 A.2d at 755.


\textsuperscript{81} See Mansha Consulting LLC v. Alakai, No. 16-00582 ACK-RLP, 2017 WL 3659163, at *15 (D. Haw. Aug. 23, 2017); \textit{see also} Marshall S. Huebner & Darren S. Klein, The Fiduciary Duties of Directors of Troubled Companies, 34 AM. BANKR. INST. J. 18, 18 (2015) (“For years, practitioners, legal scholars and even judges had struggled with whether (and when) directors and officers owed such duties to creditors as a company approached or entered insolvency.”).


\textsuperscript{86} See CML V, LLC v. Bax, 28 A.3d 1037, 1046 (Del. 2011).
3. LLC Veil Piercing

While courts have concluded that the LLC veil can be pierced in certain circumstances, LLC veil piercing continues to be an ongoing debate. Proposed solutions to this issue have ranged from reinventing the veil-piercing doctrine as applied to LLCs, to eliminating the application of veil piercing from LLCs entirely.

The standard courts will apply in LLC veil-piercing cases is unclear, as courts recognize the corporation and the LLC are vastly different in structure and purpose. However, conversely, the issue is further complicated by the misunderstanding that some courts have regarding the differences between the corporation and the LLC. Consequently, some courts automatically apply corporate law standards in LLC veil-piercing cases without much thought or deliberation.

However, some courts and legislatures including the Revised Uniform Limited Liability Company Act (“RULLCA”), have concluded that certain veil-piercing factors from corporate law should not be imported into LLC law. For example, RULLCA provides that failure to observe formalities is not grounds for imposing liability on the owners

89. See id. at 85-90 (discussing numerous proposals to alter the LLC veil-piercing test).
90. See Bainbridge, supra note 35, at 102-06.
92. See, e.g., Bernstein v. TractManager, Inc., 953 A.2d 1003, 1009-10 (Del. Ch. 2007) (“Limited liability companies and corporations differ in important ways . . . .”)
94. See Revised Uniform Limited Liability Company Act § 304(b) cmt. (Unif. Law Comm’n 2006) (“Courts regularly (and sometimes almost reflexively) apply [piercing the corporate veil] to limited liability companies.”); see also Ditty v. CheckRite, Ltd., 973 F. Supp. 1320, 1335-36 (D. Utah. 1997) (“Most commentators assume that the doctrine applies to limited liability companies.”); Bainbridge, supra note 35, at 82, 82 n.29.
95. See infra notes 101-105 and accompanying text.
of an LLC.96 Excluding the failure to observe formalities factor from the LLC veil-piercing analysis is only logical as “informality of organization and operation is both common and desired” for LLCs.97 Nonetheless, some courts continue to consider whether corporate formalities were followed in LLC veil-piercing cases.98 Additionally, domination by a single owner has been identified as a weak rationale for piercing the LLC veil. Unlike corporations—which are designed, and therefore expected to have, separation between management and ownership—LLC statutes support flexible management structures; consequently, LLCs are often member-managed firms.99 Not surprisingly, courts have observed that the domination factor is usually satisfied for LLCs.100

As a result of this lack of uniformity, some states have not left the LLC veil-piercing question to the courts. For example, LLC statutes in California, Georgia, and Minnesota mandate courts apply corporate law standards.101 On the other hand, many LLC statutes—most notably, the DLLCA—do not have such a requirement and are silent on the issue.102 Other jurisdictions, such as Wyoming, take a more nuanced approach. Specifically, Wyoming’s LLC statute prohibits courts from considering “factors intrinsic to the character and operation of” the LLC, such as failure to observe formalities relating the LLC’s powers or management and domination by a single owner.103 By contrast, Wyoming courts may consider fraud, inadequate capitalization, commingling of assets, and “[f]ailure to observe company formalities as required by law.”104 Additionally, interestingly, fraud is a dispositive factor to impose liability in Wyoming.105

In short, LLC veil piercing can best be described as “murky,”106 and no universal consensus has emerged from courts or legislatures.

97. Revised Uniform Limited Liability Company Act § 304(b) cmt (Unif. Law Comm’n 2006).
104. Id. § 17-29-304(c).
105. Id.
106. Ribstein & Keatinge, supra note 91, § 12.3.
III. VOLUNTARY CREDITORS AND LLC VEIL PIERCING

As it stands, veil piercing is generally applied equally to corporations and LLCs regardless of whether the creditor is voluntary or involuntary. However, such broad application of the doctrine ignores important considerations with respect to the type of creditor, the contractual nature of the LLC, and conflicting business law doctrines. This Section takes these considerations into account and discusses the statutory support and doctrinal differences between the corporation and the LLC to establish that voluntary creditors should not be permitted to pierce the LLC veil.

A. STATUTORY SUPPORT

Because Delaware “dominates the market” for LLCs, an analysis of the DLLCA is a logical starting point. Several provisions of the DLLCA support the argument that voluntary creditors should not be permitted to pierce the LLC veil. Indeed, Delaware courts have observed that the DLLCA “includes specific statutory features that appear designed (at least in part) with creditors in mind, and which creditors can use to obtain additional rights and protections.” Accordingly, because LLCs “are creatures of contract, designed to afford the maximum amount of freedom of contract,” voluntary creditors can protect themselves through their contractual agreements with the firm under the DLLCA.

As a baseline, section 18-101(7) of the DLLCA allows a firm’s operating agreement “to provide rights to any person, including a person who is not a party to the [operating] agreement.” Thus, assuming the voluntary creditor is sophisticated, the creditor can bargain for express terms intended to decrease the likelihood that the firm will default on its obligations while remaining a nonparty to the operating agreement. Further, the creditor can even condition approval of an amendment to the operating agreement on the satisfaction of specified conditions or creditor consent. Similarly, as an enforcement mechanism, the voluntary creditor may use other provisions of the DLLCA

107. ALLEN ET AL., supra note 54, at 68-69.
110. See DEL. CODE ANN. tit. 6, § 18-1101(b); see also Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 787 (Del. Ch. 2004) (“It is presumed that creditors are capable of protecting themselves through the contractual agreements that govern their relationships with firms.”).
111. DEL. CODE ANN. tit. 6, § 18-101(7).
112. See id. § 18-302(e) (“If [an LLC] agreement provides for the manner in which it may be amended, including by requiring the approval of a person who is not a party to
to include penalty clauses in the operating agreement if the creditor’s rights are breached or upon the occurrence of some specified event.\textsuperscript{113}

Moreover, voluntary creditors can even bargain for their own fiduciary duties in the operating agreement. Even though creditors of an insolvent LLC cannot bring derivative suits for breach of fiduciary duty\textsuperscript{114} (unlike corporate creditors),\textsuperscript{115} section 18-1101 provides that “member[s]’ or manager[s]’ . . . [fiduciary] duties may be expanded . . . by provisions in the [LLC] agreement.”\textsuperscript{116} Such a provision may be more common than expected in closely held LLCs,\textsuperscript{117} as voluntary creditors often require the owners of a firm to personally guarantee the performance of the firm’s obligations.\textsuperscript{118} Indeed, the DLLCA expressly permits such an arrangement by providing that “a member or manager may agree to be obligated personally for any or all of the debts, obligations and liabilities of the [LLC].”\textsuperscript{119} This type of personal guarantee acts similar to a contractual lifting of the veil. Relatedly, similar to a member bringing a derivative suit,\textsuperscript{120} the DLLCA gives creditors the right to enforce a member to make contributions to the LLC if the creditor “reasonably relied” on the member’s obligation to make a contribution.\textsuperscript{121} Usury is not a defense,\textsuperscript{122} nor is an inability to contribute because of death, disability, or some other reason.\textsuperscript{123}

If creditors want to get creative, they can use the DLLCA’s series LLC provision to attach a security interest in a specific asset. An op-
A operating agreement can establish one or more series of LLC assets that “may have separate rights, powers or duties with respect to specified property or obligations of the [LLC] or profits and losses associated with specified property or obligations.” Thus, while members may be able to utilize the series LLC provision to protect their assets in a similar fashion to the shareholder in Walkovszky v. Carlton, a creditor can just as effectively attach a security interest to an asset that the borrowing LLC cannot use until it satisfies its obligation to the creditor. Finally, in some circumstances, section 18-805 of the DLLCA permits a creditor of a cancelled LLC (i.e., dissolved and wound up) to protect itself by securing the appointment of a trustee or a receiver. Alternatively, as a general matter, creditors of an LLC have a common law right to apply for a receiver.

In sum, by default, LLC voluntary creditors have numerous avenues under the DLLCA to bargain for protection. Thus, because LLC voluntary creditors are granted these opportunities, allowing them to pierce the veil would afford them another opportunity to alter their agreements with the firm ex post. Of course, including these types of provisions would require some sophistication on behalf of the creditor. Indeed, commentators who argue for the preservation of LLC veil piercing claim unsophisticated parties would be unprotected without veil piercing. However, as previously noted, veil piercing does not appear to be rooted within concerns of inequitable bargains. Moreover, there are other doctrines, such as negligent and fraudulent misrepresentation, that are better situated for addressing these concerns. Therefore, while utilization of the DLLCA’s contractual privileges may require some sophistication on the part of the voluntary creditor, veil piercing is not needed to protect the interest of unsophisticated creditors.

124. Id. § 18-215.
125. 223 N.E.2d 6 (N.Y. 1996).
127. See id. § 18-805.
129. See Bainbridge, supra note 35, at 96-97 (“Where a contract creditor fails to bargain around the limited liability default rule, there is no justification for giving it a second bite at the apple through a veil piercing remedy.”).
130. See Geoffrey Christopher Rapp, Preserving LLC Veil Piercing: A Response to Bainbridge, 31 J. Corp. L. 1063, 1083 (2006) (“Just as an LLC is most likely a small business, those who engage in commerce with that LLC are most likely to be small businesses or individuals.”).
131. See id. at 1082-84.
132. See supra notes 34-37 and accompanying text.
133. See infra Section IV.B.
The DLLCA also includes provisions that implicitly suggest voluntary creditors should not be able to bring claims against an LLC’s members if those claims are not grounded in contract. Specifically, sections 18-1001 and 18-1002 of the DLLCA “both create[ ] the right to sue derivatively on behalf of an LLC and expressly limit[ ] that right to ‘member[s]’ or ‘assignee [s].’”134 By contrast, the Delaware General Corporation Law Act does not expressly limit derivative standing to shareholders.135 Further, the Supreme Court of Delaware has expressly held that creditors of an insolvent corporation have standing to bring claims derivatively for breach of fiduciary duty.136 This difference in treatment for corporations and LLCs is likely intentional: as LLCs are primarily creatures of contract, it would be logical for the DLLCA to limit the claims of LLC voluntary creditors to those grounded in contract. Consequently, veil piercing provides voluntary creditors with an opportunity to bring noncontractual claims, which contradicts other provisions of the DLLCA and the holdings of the Supreme Court of Delaware.

Moreover, other provisions of the DLLCA support greater protection for LLC participants than corporate participants.137 Specifically, section 18-303 provides that members and managers of an LLC cannot be held personally liable for any debts or obligations of the LLC “solely by reason of being a member or . . . a manager.”138 In other words, unlike corporate law, insulation from liability is extended to LLC management by default.139 Further, compare other LLC statutes—such as Wyoming’s—that include similar “solely by reason” language, but also expressly include circumstances where LLC veil piercing is

134. CML V, LLC v. Bax, 28 A.3d 1037, 1046 (Del. 2011). See also Del. Code Ann. tit. 6, § 18-1001 (“A member or an assignee of [an LLC] interest may bring an action . . . in the right of [an LLC] to recover a judgment in its favor if managers or members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed.”); id. § 18-1002 (“In a derivative action, the plaintiff must be a member or an assignee of [an LLC] interest . . . .”).
135. See Del. Code Ann. tit. 8, § 327; see also CML V, LLC v. Bax, 6 A.3d 238, 242 (Del. Ch. 2010) (“Section 327 demonstrates that the General Assembly can readily adopt a non-exclusive limitation on derivative standing. Section 18-1002, by contrast, uses exclusive language.”).
137. See O’Neal & Thompson, supra note 60, § 2.7 (“Some [LLC] statutes purport to provide insulation against liability of participants greater than that provided in corporate form.”).
139. See also Bainbridge, supra note 35, at 83, 83 n.32.
permitted. While it is doubtful courts will expand insulation for LLC participants beyond corporate participants based on section 18-303 alone, it is at least persuasive when considered in conjunction with the DCLLA’s other provisions.

An obvious and fair response to all this statutory interpretation is that if legislatures wanted to prohibit veil piercing in LLCs, then they could have easily included anti-piercing language in their LLC statutes. However, the converse can be argued just the same in jurisdictions such as Delaware: if legislatures wanted courts to apply corporate veil piercing to LLCs, then they could have easily included veil-piercing language in their LLC statutes. Indeed, as noted above, many states have, in fact, included such language in their LLC statutes. Further, this argument also assumes that an LLC statute must expressly prohibit a corporate-law doctrine for that doctrine not to apply to LLCs. Yet, despite the absence of express language in the DLLCA, the Supreme Court of Delaware has interpreted the DLLCA to prohibit derivative standing for LLC creditors when the firm is insolvent. In fact, the Delaware Chancery Court used the same provisions from the DLLCA analyzed above to conclude that LLC creditors never have standing to bring breach of fiduciary duty claims. In sum, arguing that veil piercing applies to LLCs merely because the legislature did not expressly prohibit it in the statute does not hold much weight.

B. DIFFICULTY AND CONFUSION WITH IMPORTING CORPORATE LAW STANDARDS

Another justification for eliminating LLC veil piercing for voluntary creditors is the differences between the corporation and the LLC.

As a threshold matter, there is nothing absurd about different legal principles applying to corporations and LLCs. “Because the conceptual underpinnings of the corporation law and Delaware’s [alternative entity] law are different, courts should be wary of uncriti-
LLCs utilize a partnership-like governance structure, and the LLC has been the predominant entity choice for closely held businesses. Like any close firm—especially those with a governance structure similar to a partnership—one could expect members of an LLC to be more involved in the management of the firm. Indeed, it is even more reasonable to expect such a thing in LLCs because LLC statutes typically authorize—by default—flexible governance structures. By contrast, “the corporation’s statutorily-prescribed governance structure is a hierarchical one which mandates the separation of ownership and control.” In other words, without specific facts suggesting otherwise, creditors may expect—by default—there to be adequate separation between a corporation’s owners and managers. Thus, allowing voluntary creditors to use the LLC’s expected characteristics against it through veil piercing is an unfair consequence that is not shared by the corporation.

Moreover, the differences in the corporation and the LLC remain a confusion for many courts. While this Article does not argue for the total elimination of veil piercing, perhaps the confusion surrounding veil piercing would be mitigated if we reduced the opportunity in which courts may use the doctrine. Indeed, commentators have already suggested replacing veil piercing with other doctrines, such as actual fraud, because so many of the most important corporate-veil-piercing factors should not apply in LLC veil-piercing cases. Similarly, courts may give too much weight to other factors imported from corporate law, such as undercapitalization, because they recognize certain factors, such as failure to follow formalities and domination by

148. See supra notes 53-55 and accompanying text.
149. See DEL. CODE ANN. tit. 6, § 18-102 (requiring “the words ‘Limited Liability Company’ or the abbreviation ‘L.L.C.’ or the designation ‘LLC’” be in any Delaware LLC’s name).
150. See, e.g., O’Neal & Thompson, supra note 60, § 5.2.
151. See, e.g., Del. Code Ann. tit. 6, § 18-1101(b) (“It is the policy of [the DLLCA] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”); see also Presser, supra note 17, § 4.2 (noting it is the legislative intent of LLC statutes to allow small, one-person businesses).
152. Bainbridge, supra note 35, at 103.
153. See O’Neal & Thompson, supra note 60, § 5.3 (“Reference to contract has a somewhat longer reach in LLC law [than in corporate law]. . . . Contract plays a greater role in LLCs than in organizing close corporations in part because of differences in the statutes governing each form of business.”).
154. See supra notes 93-94 and accompanying text.
155. See Presser, supra note 17, § 4.2.
a single owner, are inapplicable in the LLC context. Consequently, startup companies, which typically lack adequate capitalization, may be deterred from using the LLC despite its numerous benefits in fear of personal liability.

Finally, by eliminating veil piercing for voluntary LLC creditors, we reduce the likelihood that courts will reach the wrong result. Recall that voluntary creditors are less successful than involuntary creditors. Thus, without voluntary creditors bringing veil-piercing claims, the percent of meritorious claims will increase overall via involuntary creditors. Consequently, courts will be less likely to reach the wrong conclusion.

C. Conflicting Doctrines: Breach of Fiduciary Duty and Veil Piercing

Recall that the DLLCA permits the fiduciary duties of members, managers, or other persons that are a party to, or bound by, the operating agreement to “be expanded or restricted or eliminated by the [operating] agreement.” So if an LLC’s operating agreement eliminates management’s duty of care and loyalty—thereby preventing the firm’s members from bringing a derivative action for decisions that could be considered breaches of management’s fiduciary duties (if it had any)—should the firm’s creditors be permitted to hold management liable for those very same decisions?

Consider the fact that many common veil-piercing factors—such as significant undercapitalization, domination of the firm’s operations, failure to observe formalities, intermingling of assets, and absence of records—are merely business decisions of the firm’s management. Assume, first, that an LLC waives management’s fiduciary duties—meaning, regardless of whether it did, in fact, breach any duties, the LLC’s owners cannot sue management for these types of decisions. Even if the LLC did not waive management’s fiduciary duties, the business judgment rule would almost certainly prevent the owners from succeeding on a derivative action that challenged these decisions as management is merely required to “attribute [its decisions] to any rational business purpose.” Regardless, the LLC’s creditors can use

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156. Id. (discussing cases).
157. See supra note 30 and accompanying text.
159. See Sinclair Oil Corp. v. Levi, 280 A.2d 717, 720 (Del. 1971) (emphasis added). For example, perhaps undercapitalization was the result of an investment that turned out poorly. Further, the domination of the firm’s operations was because management feared it would be in breach of its fiduciary duty of care if it was not involved in the affairs of the firm. See Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985). Additionally, the decision to forgo formalities or keep records was because management had been so busy running the firm that it believed focusing on the firm’s operations was
these decisions as proof that the LLC’s management manipulated the limited liability form (i.e., the first prong of most veil-piercing tests) in a veil-piercing claim.

Additionally, consider the fact that many of the rationales for piercing the veil are comparable to breaches of management’s duty of good faith (i.e., a subcomponent of the duty of loyalty). First, management breaches its duty of good faith by acting fraudulently or for failing to disclose all material facts in a transaction involving owners.\textsuperscript{160} Likewise, courts pierce the veil when owners of a firm make false statements or misrepresentations to obtain credit.\textsuperscript{161} Second, management breaches its duty of good faith if it consciously fails to monitor its actions or its agents for bad acts.\textsuperscript{162} Similarly, commentators have noted courts will pierce the veil for involuntary creditors to discourage inadequate oversight by the firm’s management.\textsuperscript{163} Third and finally, management breached its duty of good faith if its actions were illegal.\textsuperscript{164} Equally, courts will pierce the veil to enforce a regulatory scheme that the firm’s owners have tried to circumvent through incorporation or formation.\textsuperscript{165} It is also worth noting that not only are these rationales for piercing the veil but also evidence of unfair or inequitable conduct (i.e., the second prong of most veil-piercing tests).

Granted, this argument is a stretch as there are more nuances to the duties of care and loyalty. Nonetheless, the interesting crossroads between these doctrines demonstrate a conflict with permitting creditors to sue management (vis-à-vis veil piercing) over decisions that insiders of a firm cannot challenge (either because of the business judgment rule or because the LLC waived management’s fiduciary duties).\textsuperscript{166} Moreover, consider a further complication if the creditor was a party to the operating agreement and the operating agreement waived management’s fiduciary duties. Should creditors receive more rights than they expressly bargained for via veil piercing by challenging decisions that would have been breaches of the duties of care or

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more important than mere formalities. See O’Neal & Thompson, supra note 60, § 1.33 (noting “the board is often viewed as only a legal formality” in close corporations). Finally, the intermingling of assets was due to the managers need for salaries; however, if they ever took more than was needed to maintain their cost of living, they put the extra back.

160. See supra note 76 and accompanying text.
161. See Macey & Mitts, supra note 18, at 113.
162. See supra note 78 and accompanying text.
163. See Macey & Mitts, supra note 18, at 128.
164. See supra note 79 and accompanying text.
165. See Macey & Mitts, supra note 18, at 115.
166. See also Phillip I. Blumberg, The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations 8 (1983) (“[Veil piercing] does not contribute to legal understanding because it is an intellectual construct, divorced from business realities . . . .”).
Furthermore, the conflict is additionally complicated by the fact that creditors of an insolvent corporation can bring claims derivatively for breach of fiduciary duty, while creditors of an insolvent LLC cannot. If we accept the similarities between veil piercing and breach of fiduciary duty claims (especially their shared trait of insolvency), then veil piercing allows voluntary LLC creditors to challenge business decisions Delaware courts have expressly prohibited them from challenging.

Perhaps the intersection of veil piercing and breach of fiduciary duty claims has broader implications across business law in general. For now, it at least demonstrates veil piercing creates a conflict in LLC law that should not be ignored. If courts can conclude that voluntary creditors are not entitled to fiduciary protection because of their ability to bargain for contractual protections, then voluntary LLC creditors should not be permitted to challenge those very same business decisions via veil piercing.

IV. MOVING BEYOND VEIL PIERCING’S BLANKET APPLICATION

*If truth were not often suggested by error, if old implements could not be adjusted to new uses, human progress would be slow.*

—Justice Oliver Wendell Holmes

Based on the above discussion, we can conclude that voluntary LLC creditors should not be permitted to pierce the veil. This Section argues the distinction between voluntary and involuntary LLC creditors remains important, and that veil piercing should still be utilized in limited circumstances involving involuntary creditors. This Section also discusses the next steps courts and legislatures should take to prevent any further LLC veil piercing by voluntary creditors.

A. JUSTIFYING UNEQUAL TREATMENT: INVOLUNTARY CREDITORS

In general, there is no reason why courts must treat voluntary and involuntary creditors the same. In fact, courts currently do not treat voluntary and involuntary creditors the same for veil-piercing

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167. *See In re BH S & B Holdings LLC*, 420 B.R. 112, 145 n.13 (S.D.N.Y. Bankr. 2009) (“Even creditors may be ‘otherwise bound’ by an LLC agreement that expressly waives fiduciary duties as between the LLC’s members.”).


170. *Cf. Bainbridge, supra* note 35, at 97-99 (arguing that abolition of the veil-piercing doctrine is preferable to reform).
purposes. Nevertheless, courts need to go further, as there are numerous reasons why voluntary creditors should not receive the same protections as involuntary creditors.

First, because there is no contract between the creditor and the firm, involuntary creditors are the same for both LLCs and corporations. Thus, many of the statutory and fiduciary duty arguments from above are not applicable. Second, and relatedly, unlike voluntary creditors, “it can hardly be argued that an involuntary creditor of an LLC consented to the creation of the LLC’s contract.” Thus, involuntary creditors are not offered the same opportunities granted by the DLLCA to protect themselves. Piercing the veil for involuntary creditors does not conflict with basic contract law, as is the case for voluntary creditors who are granted an ex post opportunity to protect their investments through veil piercing.

Third, many of the negative externalities of limited liability—for example, putting hazardous activities in separate subsidiaries or series LLCs—and consequently, the resulting need to pierce the veil, are the result of firms attempting to evade tort damages. Thus, allowing involuntary creditors to pierce the LLC veil prevents those who wish to abuse limited liability in the most egregious of ways. Fourth and finally, forcing involuntary creditors to seek recovery through other doctrines related to fraud would subject them to greater litigation cost than voluntary creditors. Claims that involve some aspect of fraud, such as actual fraud or fraudulent conveyance, have high pleading and burden of proof requirements, and consequently, high discovery cost. As a result, because involuntary creditors do not have voluntary creditors’ opportunities to investigate and monitor firms, involuntary creditors will be required to conduct more discovery, and therefore, be subject to greater litigation cost.

B. Protecting the Veil: Voluntary Creditors

Courts and legislatures must recognize that voluntary creditors should not be permitted to pierce the LLC veil. Jurisdictions that require corporate-veil-piercing standards to be applied in LLC veil-piercing cases should amend their LLC statutes to eliminate such pro-

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171. See supra note 30 and accompanying text.
172. Cohen, supra note 51, at 488.
In jurisdictions that do not have such statutory requirements, the task is easier. Conversely, for courts in jurisdictions that do not have such statutory requirements, the task is easier. “[C]reditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights.” Indeed, there are a wide variety of other doctrines that can protect voluntary LLC creditors. Some may argue that the greater pleading requirements and discovery cost for claims couched in fraud will hinder voluntary creditors from bringing claims. However, such an argument ignores the fact that the lack of predictability in veil-piercing cases “results in a situation in which creditors lack the disincentive to sue—and defendants lack the incentive to settle.” Thus, because veil piercing is already a haphazardly applied doctrine, it is doubtful its removal will have any significant impact for voluntary LLC creditors.

Additionally, while courts assume that all creditors are sophisticated enough to draft sufficient contractual protections, courts will now be required to analyze the sophistication of voluntary LLC creditors more thoroughly. Indeed, the doctrines of fraudulent and negligent misrepresentation will prove to be invaluable causes of action for those unsophisticated voluntary LLC creditors who were not able to utilize the DLLCA’s contractual protections.

V. CONCLUSION

While veil piercing may be applied incoherently and haphazardly, there may be predictable rationales courts use to pierce the veil. Nonetheless, veil piercing’s application and rationales for voluntary LLC creditors contradict both the DLLCA (and similar statutes that pattern the DLLCA) and LLC law in general. This Article demonstrates that the DLLCA grants voluntary LLC creditors numerous opportunities to protect themselves. In fact, permitting voluntary creditors to pierce the LLC veil may be inconsistent with the DLLCA

175. See Presser, supra note 17, § 4.2 (“[M]ember-managers should take care that formalities are followed to the extent possible to avoid risk of personal liability until the courts have determined that certain corporate standards are inappropriate for LLCs, or until the relevant statutes are amended.”).

176. See id.


178. Macey & Mitts, supra note 18, at 105.

and LLC common law, such as fiduciary duties. Accordingly, courts and legislatures should prevent any further LLC veil piercing by voluntary creditors.