

The Delaware LLC is Not a Corporation and Should Be Subject to a Different Veil Piercing Analysis

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“Veil piercing” is an equitable remedy that allows a plaintiff with a claim against an entity to obtain relief from the entity’s owners, in spite of laws providing for limited liability. When the owners provide personal guarantees or otherwise contract around liability protections, or when the owners are sued in their own right based on their own conduct, it is not necessary to pierce a veil of limited liability. True veil piercing – where the owners are asked to stand in for acts of the entity – is an extraordinary remedy to be reserved for the most extreme cases.

Courts generally have reviewed several factors, with varying degrees of emphasis, when determining whether to pierce the veil of a corporation. These have included the existence of fraud, adherence to “corporate formalities” such as holding and documenting meetings, the level of capitalization, whether a dominant stockholder siphoned funds from the corporation, and whether investors are so active in the management of the corporation that the corporation is their “alter ego” or “instrumentality.” Fraud may, depending on the circumstances, provide an independent basis for the liability of stockholders and others on the grounds that individuals are being found liable based on their own conduct. Other factors supporting veil piercing also often stand in as proxies for fraud, or reasons to suspect fraudulent behavior.

As has become increasingly clear, Delaware “alternative entities” such as limited partnerships and limited liability companies are not the same thing as corporations. While many of the same fiduciary principles applicable to corporate fiduciaries may apply under certain circumstances to the fiduciaries of an alternative entity, courts must remain sensitive to distinctions in entity law. In the context of veil piercing, these distinctions suggest that a Delaware LLC should not be subject to true veil piercing at all, as opposed to the imposition of liability under standard concepts of fraud, fraudulent conveyance, etc.; and that assuming the LLC’s veil may be pierced, any piercing should be subject to different standards than those applicable to piercing the corporate veil.

Section 102(b)(6) of the Delaware General Corporation Law (“DGCL”) states that a certificate of incorporation “may” contain “[a] provision imposing personal liability for the debts of the corporation on its stockholders to a specified extent and upon specified conditions; otherwise, the stockholders of a corporation shall not be personally liable for the payment of the corporation’s debts except as they may be liable by reason of their own conduct or acts.” 8 *Del. C.* § 102(b)(6). Thus, under the DGCL, the default rule is that stockholders are not personally liable for corporate debts based on their ownership of stock, but may be liable as a result of their own conduct, and may also agree in the charter to be liable to a specified extent and upon specified conditions.

Section 18-303(a) of the Delaware Limited Liability Company Act (“DLCCA” or “Delaware LLC Act”) states that

Except as otherwise provided by this chapter, the debts, obligations and liabilities of a limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company, and no member or manager of a limited liability company shall be obligated personally for any such debt, obligation or liability of the limited liability company solely by reason of being a member or acting as a manager of the limited liability company.

Section 18-303(b) of the DLCCA goes on to state that:

Notwithstanding the provisions of subsection (a) of this section, under a limited liability company agreement or under another agreement, a member or manager may agree to be obligated personally for any or all of the debts,

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obligations and liabilities of the limited liability company.

Thus, just as a stockholder may agree voluntarily in a charter provision to be liable for corporate debts to a certain extent under certain conditions, a member or manager of an LLC may agree voluntarily in the LLC agreement or another contract to be obligated personally for the LLC's obligations.

Unlike section 102(b)(6) of the DGCL, section 18-303(a) does not contain the “except as they may be liable by reason of their own conduct or acts” proviso. However, section 18-303(a) refers only to debts, obligations, and liabilities of the LLC, and also states that members and managers shall not be liable “solely” by reason of being a member or acting as a manager. Courts have interpreted this language to mean that managers and members may continue to be liable for their own independent debts, obligations, and liabilities. Again, when such a determination is made it is unclear that there is any “veil piercing” at all, as opposed to the plain vanilla application of tort and contract liability principles.

Other provisions of the Delaware LLC Act represent public policy choices that are inconsistent with the rote application of corporate veil piercing standards to an LLC. For example, the policy of the DLLCA is “to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.” 6 *Del. C.* § 18-11011(b). More specifically, the DLLCA contemplates that an LLC agreement may restrict or even eliminate all duties or liabilities of a member or manager other than for the implied contractual covenant of good faith and fair dealing. 6 *Del. C.* § 18-11011(c),(e). Taken together, these provisions stand for the proposition that “contract is king” for the LLC. The organizers of an LLC are permitted to borrow concepts from a corporation, but are not required to, and can organize themselves in potentially infinite ways.

Thus, Delaware LLCs lack “corporate formalities” by design. Even in a corporation, “corporate formalities” exist for the protection of stockholders, not third parties, and are a relatively weak justification for veil piercing. Corporate formalities may be relevant to veil piercing to the extent that they suggest a corporation is a sham entity that exists only to facilitate fraud or other inappropriate conduct. However, evaluating LLC management with the same jaundiced eye is inconsistent with the fundamental principle that an LLC is not the same thing as a corporation and is to be operated however the parties choose in their LLC Agreement.

Even more significantly, section 18-1101(j) of the DLCCA provides that “[t]he provisions of this chapter shall apply whether a limited liability company has 1 member or more than 1 member.” The statute expressly contemplates that many LLCs will have only one member, and provides that the same principles (which include maximum freedom of contract and limited liability) are to apply equally to those LLCs. It is currently estimated that the vast majority of Delaware LLCs are not publicly traded and are closely held. As with a lack of “corporate formalities,” then, LLCs are likely to have a “unity of interest” by design. In a small start-up company formed as an LLC, the same person often will be the single member and manager of the LLC, and will make all decisions for the business. If that is not an acceptable state of affairs, then the LLC cannot have limited liability in most circumstances, thus thwarting legislative policy.

Corporations and LLCs also are generally formed for different reasons. The primary reason for forming a corporation is to amass large amounts of capital through the capital markets. The primary reason for forming an LLC is to limit the liability of its members for decisions they make themselves. Although one can debate the efficiency of conferring limited liability on single-member start-up companies, that is a decision best made by a legislature and not by judges on an *ad hoc* basis.