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PIERCING THE VEIL IN CALIFORNIA LLCs: ADDING SURPRISE TO THE VENTURE CAPITALIST EQUATION

Eric W. Shu*

I. INTRODUCTION

Venture capitalists diversify their portfolios in order to protect the overall investment.¹ The theory behind this practice is that even if several of the portfolio companies squander all of the capital contributed to them, one or more of the other funded companies may produce profits that far exceed the aggregate loss from the unsuccessful companies, thus making the overall venture worthwhile.² Each company invested in by venture capitalists has the potential to achieve this kind of success.³ Now suppose each company in the portfolio also had the ability to cause liability that exceeds the contribution made to it, destroying the venture capitalist’s entire fund. This is the type of damage that the doctrine of veil-piercing

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can bring to the field of venture capitalism.⁴

This possibility is a particularly pertinent problem in California, an area speckled with high-tech and biotech businesses that have enjoyed heavy venture capital outlays.⁵ Besides serving as high-yield investments for venture capital investors, venture-backed businesses have accounted for thousands of jobs in California alone⁶ and have brought many new innovative high-tech products to society.⁷ Although California has shared in the venture capitalists' success,⁸ it has unintentionally discouraged venture capital investment into small businesses.⁹ This is ironic because California attempted to foster the formation of these businesses by enacting the Beverly-Killea Limited Liability Company ("LLC") Act,¹⁰ which allows California businesses to organize as a limited liability company entity.¹¹ Unfortunately, that Act imports the common-law doctrine of piercing the corporate veil into LLC law.¹² This doctrine discourages investments into venture capital funds.¹³

This comment advocates the elimination of the veil-piercing doctrine from California LLC jurisprudence, and cites its impact on venture capital financing and on small business growth as two of the many reasons to eliminate it.¹⁴

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5. See infra Part II.D.
7. DOERFLINGER & RIVKIN, supra note 1, at 180 (citing the development of most computer technologies as the product of corporate investors acting as venture capitalists).
9. See infra Part III.
12. CAL. CORP. CODE § 17101(b) (West Supp. 2005).
13. See infra Part IV.A.
14. For general reasons to abolish the doctrine, see generally Stephen M.
It draws upon arguments that have been made in the corporate law context, but distinguishes aspects unique to LLCs. To that end, Part II briefly discusses the LLC entity, the doctrine of veil-piercing, the role that venture capitalists play, and the position California has taken towards small businesses, particularly those in the high-tech sector. Part III of this comment identifies the problem with the current liability scheme. Part IV dissects the perverse incentives created by the veil-piercing liability system and discusses the attributes of an ideal system. Finally, Part V concludes with a proposal to reform the LLC entity into one that is consistent with California's best interests, encourages venture capitalists to behave rationally, and allows the LLC to mature into a form distinct from the corporate entity.

II. BACKGROUND

A. LLCs

Prospective entrepreneurs face many important decisions before they begin their business dealings, such as which type of entity the business should use to conduct its commerce. California law allows entrepreneurs to choose from many entity forms, including the sole proprietorship, the corporation, the general partnership, the limited partnership, the limited liability partnership ("LLP"), and the

15. See infra Part II.B. Professor Stephen M. Bainbridge advocated elimination of the veil-piercing doctrine from corporate jurisprudence in an article entitled Abolishing Veil Piercing, 26 J. CORP. L. 479 (2001). Some of his arguments are relied upon here.
16. See infra Part II.
17. See infra Part III.
18. See infra Part IV.
19. See infra Part V.
21. Id.
23. Id. See also CAL. CORP. CODE §§ 1-19 (West 1990).
24. California Secretary of State, supra note 22. See also CAL. CORP. CODE §§ 16100-16114 (West Supp. 2005).
25. California Secretary of State, supra note 22. See also CAL. CORP. CODE §§ 15501-15533 (West 1990).
newest permissible form, the limited liability company.\textsuperscript{27} Entrepreneurs determine which entity type is the most appropriate for their forthcoming businesses by considering several factors, including cost of formation, transferability of interest, lifespan of the entity, profit and loss distribution among owners, management system, taxation, and liability.\textsuperscript{28}

A popular entity form that has long been recognized under California law is the corporation.\textsuperscript{29} In contrast to partnerships, where the entity is simply the sum of all the partners,\textsuperscript{30} a corporation has an existence separate and distinct from its owners.\textsuperscript{31} The artificial personality of the corporation is, of course, a legal fiction, and therefore practitioners often describe the two identities as being separated by a "veil."\textsuperscript{32} The existence of two separate entities implies that shareholders should not be held liable for the corporation's debts and obligations.\textsuperscript{33}

Non-liability has been rationalized on several grounds, but one of the most frequently cited reasons is that the use of a rule allowing personal liability would ultimately harm society by inhibiting economic growth.\textsuperscript{34} If investors can be held personally liable for the actions of the companies in which they invest, they will be discouraged from diversifying their investments.\textsuperscript{35} The cost of prudent investing (i.e., the cost of monitoring the company invested in) increases with the number of companies invested in, not with the amount invested.
per company.\textsuperscript{36} Therefore, investors will be best served by making one large investment into a single company.\textsuperscript{37} Diversification is central to many investors' risk-reduction strategies.\textsuperscript{38} Consequently, any hindrance of the ability to diversify increases the risk of investing.\textsuperscript{39} This higher risk is a cost ultimately borne by society since businesses will grow less rapidly because the price of securing investment capital will be higher.\textsuperscript{40} To avoid this dilemma altogether, corporate statutes limit the personal liability of investing shareholders to their initial investment.\textsuperscript{41}

The LLC is a relatively new hybrid entity that combines the tax transparency of a partnership with the limited liability aspect of a corporation.\textsuperscript{42} The LLC form was designed to foster the formation of small businesses\textsuperscript{43} and addresses many of the impediments that other entity forms did not.\textsuperscript{44} Some entities subjected business owners to unlimited personal liability, some required the business owners to pay a double tax, and others hindered the owners' discretion in managing their own businesses.\textsuperscript{45} By selecting the LLC entity, small business owners could avoid each of these drawbacks.\textsuperscript{46}

While shareholders of a corporation may not manage the company while acting in the capacity of a shareholder,\textsuperscript{47} in contrast, LLC members are permitted to handle even the day-to-day operations of the business while still enjoying the protection of the veil.\textsuperscript{48} Small businesses generally require flexi-

\begin{thebibliography}{99}
\bibitem{36} See id.
\bibitem{37} Id.
\bibitem{38} Id.
\bibitem{39} Id.
\bibitem{40} Bainbridge, supra note 14, at 491.
\bibitem{41} Id. at 293.
\bibitem{42} BALLANTINE, supra note 10, § 900.02[2].
\bibitem{43} Id. § 900.02[5].
\bibitem{44} Corporation shareholders were required to pay a double tax, partnership partners were subjected to unlimited personal liability, and corporation shareholders could not exercise control over the corporation's daily business. \textsc{Soderquist et al.}, supra note 28, at 37, 79.
\bibitem{45} Id.
\bibitem{46} BALLANTINE, supra note 10, § 900.02[2].
\bibitem{47} CAL. CORP. CODE § 300 (West 1990) (stating that "the business and affairs of the corporation shall be managed . . . by or under the direction of the board," not the shareholders).
\bibitem{48} CAL. CORP. CODE § 17150 (West Supp. 2005). \textit{But see} § 17157(b)(1) (stating that in a manager-managed LLC, members do not have the power to bind the business if they are not managers).
\end{thebibliography}
ble management structures, and, consequently, the California LLC statute permits operation through a member-managed or a manager-managed structure. In the former, any member's acts can bind the LLC. In the latter, only the managers have the authority to bind the LLC. Consequently, they owe fiduciary duties to the LLC and its members.

Although the LLC business structure may provide enticing incentives, LLC statutes generally do not allow all entrepreneurs to organize under the LLC form. The California statute, for example, prohibits the use of LLCs to render professional services and services in the fields of banking, trust company, or insurance.

LLCs and corporations share many similarities and have frequently been the subject of comparison. Like corporations, LLCs enjoy limited liability in that the owners cannot be held personally liable for business debts and obligations. The owners, generally, are liable only to the extent of the capital that owner has contributed to the business. Both entities are required to file articles with the Secretary of State in order to be created, and both can have perpetual duration as a lifespan.

49. See BALLANTINE, supra note 10, § 900.02[5].
51. Id. § 17157(a). However, a member's acts do not bind the LLC if the member had no authority to do so and the party dealing with that member had actual knowledge of the absence of power. Id.
52. Id. § 17157(b).
53. Id. §17153.
54. BALLANTINE, supra note 10, § 900.02[6].
56. Id. § 17002.
58. CAL. CORP. CODE §§ 17151, 17158(a) (West Supp. 2005).
59. But see id. § 17201(a)(2) (holding owners liable for unfulfilled capital commitments).
60. Corporations are required to file under California Corporation Code section 200, and LLCs are required to do the same under California Corporation Code section 17050. CAL. CORP. CODE § 200 (West 1990); CAL. CORP. CODE § 17050 (West Supp. 2005).
61. CAL. CORP. CODE § 200(c) (West 1990); CAL. CORP. CODE § 17051(c)(3)
Some LLC characteristics, however, are similar to those of corporations only if the particular organizer so chooses. Taxation is one example. Formerly, LLCs were required to maintain partnership attributes in order to qualify for single-level taxation. Current, California LLCs can simply elect to have corporate taxation or partnership taxation under the "check-the-box" system. Another example is governance structure. As stated above, LLCs can be operated through a member-managed or a manager-managed system, the latter slightly resembling the centralized management system of corporations, even though it does not call for the creation of a board of directors. A third example concerns capitalization. Unlike stock issuance in corporations, LLC membership interests can be acquired by simply promising to make future contributions.

One significant difference between LLCs and corporations is the absence of an extensive body of case law. Corporations have existed in California since the adoption of the California Constitution and have been involved in numerous cases. Whereas the bounds of the law governing corporations have been fairly well delineated, the bounds of LLC law are yet to be fully tested. In some areas, California has statutorily solved this problem by adopting aspects of corporate law into LLC law.

(West Supp. 2005).

62. ROBERT J. HAFT & MICHELE H. HUDSON, VENTURE CAPITAL AND SMALL BUSINESS FINANCING § 3:27 (9th prtg. 2004) (1984) (stating that LLCs were required to lack two of four corporate characteristics to qualify for partnership taxation).

63. Currently, the California State Board of Equalization and the Internal Revenue Service both allow LLCs to choose partnership taxation with a simple check in the appropriate box on the tax form. Compare CAL. REV. & TAX CODE § 28.5 (West 1998) (classifying LLCs as partnerships for tax purposes), and Treas. Reg. § 301.7701-3 (as amended in 2003).

64. See Callison, supra note 57, at 111-12 (noting the similarities and differences in operational management functions and control functions between LLC managers and corporation directors).

65. See id. (noting that only three states include a board of directors in the LLC statutes).

66. CAL. CORP. CODE § 17200(a) (West Supp. 2005) (permitting members to provide binding future commitments as capital contribution).

67. BALLANTINE, supra note 10, § 900.02[5].

68. A search of California corporate case law on LexisNexis retrieves more than 3,000 hits.

69. HAFT & HUDSON, supra note 62, § 3:35 (stating that there is nothing well-established or predictable about LLCs).
One instance of this approach can be found in the personal liability statute. Section 17101 of the California Corporations Code states:

[N]o member of a limited liability company shall be personally liable . . . for any debt, obligation, or liability of the limited liability company . . . . A member . . . shall be subject to liability under the common law governing alter ego liability, and shall also be personally liable . . . under the same or similar circumstances and to the same extent as a shareholder of a corporation may be personally liable for any debt, obligation, or liability of the corporation . . . . 70

Alter ego liability 71 is one of the bases for disregarding the corporate fiction (i.e., piercing the corporate veil) that occurs “where a corporation is organized and operated as a mere tool or business conduit of another corporation.” 72

B. Piercing the Veil

“'Piercing the corporate veil' refers to the judicially imposed exception to [the non-liability] principle by which courts disregard the separateness of the corporation and hold a shareholder responsible for the corporation's action as if it were the shareholder's own.” 73 All fifty states now recognize LLCs, 74 but not all states have been equally instructive on how to handle the veil-piercing doctrine. While California chose to statutorily adopt alter ego liability and other personal liability “to the same extent as a shareholder of a corpo-

70. CAL. CORP. CODE § 17101(a), (b) (West Supp. 2005).
71. For a description of the alter ego doctrine, see BALLANTINE, supra note 31, § 295.
73. Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 CORNELL L. REV. 1036, 1036 (1991). As an example, consider individual X, who incorporates his mobile home sales business and capitalizes the corporation with a promissory note, which he never pays. X neglects to maintain corporate minutes. Y, a purchaser of a defective mobile home from this business, successfully sues the corporation. If the corporation is unable to satisfy the judgment because it was never properly capitalized, arguably Y should be able to pierce the veil of the corporation and hold X personally liable. If X is allowed to argue that the corporation is a separate entity, an inequitable result will follow because X never treated the corporation as a separate entity, but nevertheless is allowed to obtain the protections of separate entity status. For a more detailed illustration, see Laya v. Erin Homes, Inc., 352 S.E.2d 93 (W. Va. 1986).
74. BALLANTINE, supra note 10, § 900.02[1].
ration" when it enacted the Beverly-Killea LLC Act in 1996, the Delaware Limited Liability Company Act chose to remain silent on the issue. The doctrine began as a common-law exception to the general rule of limited liability for shareholders in a corporation, but has become the most litigated, yet one of the most confusing, issues in corporate law. It has been noted that judicial opinions are long on rhetoric and short on reasoning, using catchwords such as "alter ego," "screen," and "instrumentality," followed by barely any substantive explanation.

Veil-piercing can occur in a number of different business structures. The simplest scenario involves holding individual shareholders personally liable for the acts of their corporation. Veil-piercing also occurs, however, in enterprise situations. In a business enterprise, multiple artificial entities are created. Often, a "parent" corporation owns some or all of the shares of a "subsidiary" corporation. If the parent corporation owns stock in multiple subsidiary corporations, those subsidiary corporations are "sibling" corporations of each other. Where justified, two veils will be pierced and the shareholders of a parent corporation will be held liable for the obligations of the subsidiary corporation. Even more extraordinary, however, is that some corporations have been held liable for the obligations of their sibling corporations (i.e., corporations that share the same parent corporation). The reach of personal liability often depends on the equities of the situation, a nebulous concept which itself can turn on many factors.

75. CAL. CORP. CODE § 17101(b) (West Supp. 2005).
76. DEL. LTD. LIAB. CO. ACT § 18-303 (2005).
77. Thompson, supra note 73, at 1036.
78. Schwindt, supra note 57, at 1556.
79. Individuals, as opposed to artificial business entities, stand as the defendant in approximately fifty-five percent of veil-piercing cases. See Thompson, supra note 73, at 1055.
80. Parent corporations have been held liable for their subsidiaries' acts in thirty-seven percent of the instances the court has faced the issue. Id. at 1055.
81. See Thompson, supra note 73, at 1057.
82. See id.
83. See id. at 1057, n.111.
85. A determination of what is equitable is within the court's discretion and is often adjudged on a case-by-case basis. DOUG RENDLEMAN, CASES AND MATERIALS ON REMEDIES 156-57 (6th ed. 1999).
In *Laya v. Erin Homes, Inc.*, the Supreme Court of West Virginia laid forth a two-prong alter-ego test that determines whether a corporate veil should be pierced in breach of contract cases. First, a determination must be made of whether the corporate formalities were disregarded and whether the personalities of the corporation and the individual have been separated. Second, the court must determine whether fairness requires piercing the veil because an inequitable result would otherwise occur. To help determine whether the first prong has been satisfied, the court enumerated factors that are instructive. Among them are the use of the corporation to perform fraudulent acts, the placement of management and ownership in the same persons, the failure to hold meetings, and the failure to adequately capitalize the corporation.

All of these factors, however, are not directly transferable to LLC law. For example, California Corporations Code Section 17101 specifically excludes the failure to hold meetings and observe formalities from the piercing analysis. This is because those actions are not required under the LLC statutes, unless elected for in the articles of organization or operating agreement. If they are so elected, the failure to observe those formalities may condition the piercing of the veil. Also rendered unnecessary under the LLC statutes is the requirement of adequate capitalization. Initial funding of an LLC business is permissive, not mandatory.

The *Laya* two-prong test has generally been followed in

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86. 352 S.E.2d 93 (W. Va. 1986).
87. Id. at 99.
88. Id.
89. Id.
90. Id. at 98-99.
91. Id.
92. LLCs have attributes that differ from those of corporations. *See supra* Part II.A. Therefore, some parts of the corporate veil-piercing doctrine cannot be cleanly imported into LLC jurisprudence.
93. CAL. CORP. CODE § 17101(b) (West Supp. 2005).
94. Id. § 17104 (making member meetings permissive, not mandatory).
95. Id.
96. Id. § 17101(b) (reinstating the observance of formalities as a veil-piercing factor where the articles of organization expressly require formalities to be observed); BALLANTINE, *supra* note 10, § 904.14[2][b].
97. CAL. CORP. CODE § 17200(a) (West Supp. 2005); 1 HAROLD MARSH ET AL., MARSH'S CALIFORNIA CORPORATION LAW § 3.05[D][1][a] (4th ed. 2005).
98. 1 MARSH ET AL., *supra* note 97, § 3.05[D][1][a].
Califonia, but *Laya* also suggested a third possible prong. The third prong is based on the theory that the piercing analysis should differ for tort cases and contract cases since only the latter involves a plaintiff who voluntarily forms a relationship with the defendant corporation. Consistent with this theory, the *Laya* court held that if, under the circumstances, it was reasonable for a contract creditor to conduct a reasonable investigation of the corporation prior to entering into a contract with it, then the contract creditor is charged with the knowledge that the investigation would have disclosed. If the investigation would have disclosed the corporation's undercapitalization, then the contract creditor is deemed to have assumed the risk that any recovery he may later obtain against the corporation would be limited. In such a case, the contract creditor would not be allowed to pierce the veil. Accordingly, many analysts expected the veil to be pierced more frequently at the insistence of a tort claimant.

In 1991, Robert B. Thompson tested this expectation by performing an empirical study of the factors that affect the court's decision to pierce the corporate veil. Thompson's results were surprising because they suggest that courts are more willing to pierce the veil when a corporation breaches a contract than when it commits a tort. In addition to this discovery, Thompson found three other significant revelations, namely that courts pierce the veil in seventy-three percent of the cases where undercapitalization is found, the doctrine applies exclusively to closely-held companies, and

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100. *Laya*, 352 S.E.2d at 100.
103. *Laya*, 352 S.E.2d at 100.
104. *Id.*
105. Schwindt, *supra* note 57, at 1563-64.
107. *Id.* at 1058.
108. *Id.* at 1064, 1065.
109. *Id.* at 1039.
California has been more inclined to pierce the corporate veil than most states.\textsuperscript{110} Thompson's statistics have been relied on in several other articles.\textsuperscript{111}

One article that relied on those figures was written by Professor Stephen M. Bainbridge and advocates the abolition of the corporate veil-piercing doctrine.\textsuperscript{112} Bainbridge begins his article by asserting the problem: judges have too much discretion in handling veil-piercing cases and, therefore, vague standards are created.\textsuperscript{113} Consequently, practitioners are unable to effectively advise their clients when personal liability may be imposed.\textsuperscript{114}

Having given a reason to think critically about the veil-piercing doctrine, Bainbridge proceeds to explain its underpinnings. First, he discusses why limited liability is the general rule.\textsuperscript{115} In contract cases, limited liability is merely a default rule which places the onus of bargaining for a personal guarantee on the party that is best situated to determine when a guarantee is necessary.\textsuperscript{116} In most cases, this is the party seeking to deal with the corporation.\textsuperscript{117} Although this "best situated" rationale cannot be applied to tort cases, limited liability is still tolerated in tort cases because otherwise, as explained above, investors would curtail their investments and the U.S. economy would suffer.\textsuperscript{118} Bainbridge then articulates the exceptions to the general rule of limited liability (i.e., instances where the veil should be pierced).\textsuperscript{119}

To complete his analysis, Bainbridge demonstrates how the policies underlying the general rule and its exceptions can be advanced equally well through an alternative liability re-
gime that is clearer and less vague than the veil-piercing sys-

120. See generally id. at 514-34.

121. See generally id.

122. Id. at 516.

123. Id. at 526-27. Abuse of the corporate form occurs where an entrepre-

124. See generally Bainbridge, supra note 14, at 534-35.

125. Where the law is governed by the theories of direct and enterprise liabil-

126. GRAHAM BANNOCK ET AL., THE ECONOMIST: DICTIONARY OF BUSINESS

127. QUINDLEN, supra note 2, at 18.
to sell the invested company to another for a higher price. Venture capital is necessary to enable entrepreneurs without sufficient capital of their own to start new businesses.

Most venture capital firms have a uniform structure. Firms are frequently organized as limited partnerships, where the limited partners consist of investors that provide capital, but seek to avoid personal liability. The limited partnership also consists of general partners who organize the funds in which the limited partners invest. The funds are normally provided by another business entity or an institutional investor, and only rarely by an individual investor.

Although venture capitalist firms can be found in many heavily populated states, most major firms operate at least a branch office in California. Specifically, most venture capitalists in California are located within a twenty-mile radius stretching out from Palo Alto. These offices are strategically placed near the high-tech businesses that have blossomed since the 1970s.

Because venture capitalists risk such a high probability of loss of their investment, they often insist that they be given a position on the board of directors in addition to their equity stake in the company. Since a position on the board of di-

128. Id.
129. JOHN BLACK, A DICTIONARY OF ECONOMICS 495 (1997).
130. National Venture Capital Association, supra note 3 (noting that limited partnerships are the predominant form of venture capital firms).
131. Id. Limited partnerships consist of general partners who manage the partnership, but are subject to personal liability, and limited partners who do not manage the firm, but have their personal assets protected. CAL. CORP. CODE § 15501 (West 1991).
132. § 15507; 4 BALLANTINE & STERLING CALIFORNIA CORPORATION LAWS § 723.02 (R. Bradbury Clark ed., Matthew Bender, 4th ed. 2004) (referring to limited partners who are pure investors, and thus should not be sued).
133. National Venture Capital Association, supra note 3 (describing the makeup of the typical venture capital firm).
134. QUINDLEN, supra note 2, at 18.
135. Id. at 18. Firms are reluctant to include personal investors as limited partners because they tend to be short-term investors that do not represent a consistent source of money through a volatile economy. Id.
136. See id. at 4.
137. Id.
138. QUINDLEN, supra note 2, at 3. One venture capitalist dubbed Sand Hill Road in Menlo Park "the financial ground zero of Silicon Valley" because almost all venture capital offices are located there. Id. at 4.
139. Id. at 18.
rectors can only be given if it exists, not all business forms are conducive to venture capital investment.\footnote{See Callison, supra note 57, at 116 (noting that, of the fifty states, only the Minnesota, North Dakota, and Tennessee LLC acts provide for a board of governors).} It is not always only the venture capitalist, however, that wants the venture capitalist firm to have a share of the management.\footnote{DOERFLINGER & RIVKIN, supra note 1, at 221 (describing the biotech industry as one short on money and industrial know-how). See also QUINDLEN, supra note 2, at 40-41 (describing the founders of Excite as immature kids who know little about how to build a business).} Start-up entrepreneurs are industrial revolutionaries who understand technology, not business. Consequently, they commonly need help commercializing their product\footnote{Id. at 13.} and often turn to venture capitalists for the business experience that will help their company succeed.\footnote{BALLANTINE, supra note 10, § 900.02[5].} The firm is able to provide that experience because of the familiarity with the start-up process it gains from other ventures.\footnote{Callison, supra note 57, at 98 ("Conventional wisdom holds that venture capital firms generally do not invest in limited liability companies . . .").}

Analysts forecasted that LLCs will have special appeal to venture capital funded high-tech companies,\footnote{Id. at 109-10. An “exit strategy” is a venture capitalist’s plan to cash out of a particular investment. See DAVID GLADSTONE, VENTURE CAPITAL INVESTING: THE COMPLETE HANDBOOK FOR INVESTING IN SMALL PRIVATE BUSINESSES FOR OUTSTANDING PROFITS 217-33 (1988), for a review of six different exit strategies. Membership interests are illiquid for two reasons. The first reason is based on the fact that the owners of the LLCs are the same people who control it. Callison, supra note 57, at 107. Since all members of a LLC are granted the power to bind the company, current members of any LLC have an incentive to restrict membership interests from flowing into the hands of investors that lack business acumen. Id. at 109. Because the membership interests are restricted, they are illiquid. A second reason which may be given is that venture capitalists often exit their investments through initial public offerings, GLADSTONE, supra at 218, and it is uncommon to find a publicly traded LLC. This latter reason, however, does not present a substantial obstacle because LLCs can be reorganized into corporations.} but several reasons exist why venture capitalists should not invest in LLCs.\footnote{Id. at 24-25.} Some cynically view the two as incompatible due to the fact that venture capitalists hold sacred the ability to exit an investment, yet LLC membership interests are inherently less liquid than corporate shares.\footnote{Id. at 24-25.} Others believe that the agency responsibilities and fiduciary duties that accompany
the manager position (and the member position in a member-managed LLC) make LLC interests unattractive.\footnote{CAL. CORP. CODE §§ 17150, 17153 (West Supp. 2005). Agency power is the power to bind. Consequently, those entrusted with that power have the highest duty imposed on them.} Those duties require venture capitalists to reluctantly forego other investment opportunities that may compete with the LLC.\footnote{Callison, \textit{supra} note 57, at 110-11. While this requirement is unobjectionable for investors who diversify their investments among many industries, it is a significant encumbrance to venture capitalists who prefer to create specialized funds, i.e., portfolios consisting of several companies from the same sector.} Finally, some believe that LLC investments are too difficult to protect and, therefore, venture capitalists should not make such investments.\footnote{Id. at 98.} In member-managed LLCs, investments are difficult to protect because, to the detriment of venture capitalists investors, all owners can exercise control, even those unqualified to do so.\footnote{Id. at 109.} In manager-managed LLCs, the difficulty stems from the fact that venture capitalist members can ensure that the managers are working in their best interests only by incurring expensive monitoring costs.\footnote{Callison, \textit{supra} note 57, at 112.}

Despite the obstacles that make LLCs poor investment vehicles, the very people who question the suitability of LLCs for venture funding also advocate the tailoring of LLC law to fit it.\footnote{See, e.g., \textit{id.} at 98.} These people recognize the link between venture capital and LLCs, namely, that both aim to foster small business growth.\footnote{See, e.g., \textit{id.}} The intention of the California legislature in creating the LLC entity was to encourage small business formation.\footnote{BALLANTINE, \textit{supra} note 10, § 900.02[5] (stating "[t]he Act is designed especially to assist the formation and operation of small, closely held or closely controlled business arrangements.").} Venture financiers then pick up where the legislators leave off by seeking to expand these small, newly formed businesses.\footnote{See KUNZE, \textit{supra} note 2, at 3 (stating that the only companies which are eligible to receive venture capital are those that can tripe in value and grow to have potential sales of at least twenty-five million dollars within six years).}
Although venture capital constitutes only a small portion of overall corporate finance in the United States, it has made a significant impact on the nation’s economy. The National Venture Capital Association (“NVCA”) released a study that indicated that thirty years of venture capital investment created 7.6 million United States jobs and has accounted for $1.3 trillion of revenue. The jobs and revenues were created not only in the computer, consumer, and healthcare industries, but also in the communications, biotech, electronics, and energy sectors. The number of venture capital deals has increased steadily throughout the United States between 1990 and 2000. In 1990, 1,433 deals were made with an average investment of $1.93 million per deal. In 2000, the number of deals reached 7,832, with an average investment of more than $13 million per deal. During the recent recession, those numbers have declined dramatically.

D. California’s Position and History

California has benefited greatly from the investment of venture funds, receiving significantly more venture capital than any other state during the three decades leading up to 2000. During that time, approximately $109 trillion was invested in California by venture capital funds. Moreover, in the year 2000 alone, venture-backed U.S. companies generated more revenue and jobs in California than in any other state. California venture-backed businesses generated approximately $270 trillion in revenue and 1.5 million jobs.
Much of these figures involved the high-tech sector in the Silicon Valley, but California has also enjoyed significant investment of venture capital in the biotech industry in the San Diego area. Venture capitalists, however, recognize that these two investments differ. Unlike the companies in the computer and semiconductor industries, small biotech companies cannot turn a quick profit and then expand by reinvesting that profit. The exact opposite occurs in biotech, where the companies often show no meaningful profit until many years after the investment is made. Although it is unlikely that many small biotech companies will be able to take their place among the Fortune 500 in the near future, the biotech industry has received its share of venture capital funding.

1. The Business without Funding: A Hypothetical

Able, an avid bioengineer, has finally developed an effective cure for the common cold. Hoping to share his invention with society and make a fair profit while doing so, Able decides to form a business to commercialize his new invention. Able forms an LLC because he cannot afford paying a double tax and he is unwilling to face unlimited liability. This busi-

170. Id.
173. DOERFLINGER & RIVKIN, supra note 1, at 215.
174. Id. See also QUINDLEN, supra note 2, at 8-14 (discussing the Internet explosion).
175. DOERFLINGER & RIVKIN, supra note 1, at 219 (discussing recombinant DNA technology). One example of such a non-commercial achievement is the elucidation of the human genome. Despite the monumental importance of this feat, it remains commercially insignificant until, at a minimum, the gene sequences are identified. Although the completion of the human genome project has scientific value, the products biotech companies hope to commercialize require post-sequencing research. See, e.g., Celera Genomics, Target Discovery & Validation, at http://www.celera.com/celera/discovery_platforms (last visited Apr. 24, 2005). The human genome is available for download, free of cost, at http://www.ncbi.nih.gov/genome/guide/human (last visited Apr. 24, 2005).
176. DOERFLINGER & RIVKIN, supra note 1, at 220. See Ballon, supra note 172, at C3.
ness entity permits him to take an active role in the management of his own company, without making an initial capital contribution.

Able, however, still needs financing to mass produce his new invention. Able is reluctant to even attempt to raise money through the solicitation of numerous individual investors because he is inexperienced in complying with the Securities and Exchange Commission’s regulations. Able, therefore, pursues funding from VenCap, a limited partnership engaged in the venture capital business. VenCap is uncomfortable with the fact that this is Able’s first business, but is confident that the business can succeed under the management of VenCap’s experienced general partners. Nevertheless, VenCap struggles with the decision of whether to invest in Able’s LLC because VenCap’s fund can only afford to finance one more business and VenCap is also considering investing in Competitor, Inc., a larger business that offers the prospect of higher returns, but requires a larger investment.\footnote{177. It is assumed here that the LLC is the smaller business because the Beverly-Killea LLC Act was aimed at helping the growth of small businesses. BALLANTINE, supra note 10, § 900.02[5].}

One reason why VenCap has limited funds is exemplified by investor \(X\). \(X\) is a sophisticated institutional investor that VenCap hopes will join as a limited partner. \(X\) recognizes, however, that because veil-piercing is a lingering possibility, \(X\) is better off making multiple, discrete investments than it is making one lump investment into a venture capital firm.\footnote{178. See supra Part II.A.} By making multiple, discrete investments, \(X\) separates each investment and prevents them from affecting one another. In contrast, if \(X\) makes a single investment into a venture capital firm, \(X\)’s entire investment can be lost if one company within the venture capitalist’s portfolio has its veil pierced. \(X\), therefore, chooses not to join VenCap.

Meanwhile, to solve the question of which business to finance, VenCap considers the costs that are associated with investing in each business. VenCap makes its decision based on the law as it stands today—where both LLCs and corporations are capable of having their veils pierced. Because veil-piercing is possible, VenCap determines it will make expenditures to monitor each company it invests in. These expendi-
tures, VenCap figures, are important because VenCap deals with relatively small companies, and these closely-held companies are the types that are the most amenable to veil-piercing. VenCap concludes that it can minimize these monitoring costs by minimizing the number of companies invested in. To do this, VenCap decides to invest in seven larger businesses, rather than to diversify over ten smaller ones. VenCap chooses to finance the larger Competitor, Inc. Able's LLC is left unfunded and society is deprived of Able's cure for the common cold.

III. IDENTIFICATION OF THE PROBLEM

"Piercing the corporate veil" began as a narrow exception to the general rule of non-liability, but the doctrine has burgeoned into the most frequently litigated issue in corporate law. By adopting the corporate standard into LLCs, the same frequency of litigation can be expected. In order to curb meritless attacks on investors and decrease the costs associated with those attacks, the current LLC liability scheme should be reconsidered.

Several reasons exist to abolish the veil-piercing doctrine from LLC jurisprudence. When the doctrine is utilized, it creates a body of law burdened by vague standards that prevent practitioners from effectively advising their clients. It also restrains the LLC entity from maturing into its proper form and differentiating itself from the corporate entity. Moreover, it imposes liability that renders the promise of lim-

179. Thompson, supra note 73, at 1039. Veil piercing does not occur in publicly traded companies. Id. Moreover, venture capitalists should be particularly careful about veil piercing since they frequently take part in the business's management—one factor in courts' decisions to pierce the veil. Id. at 1063-64.
180. Id. at 1036.
181. CAL. CORP. CODE § 17101(b) (West Supp. 2005).
182. None of the differences between the LLC entity and the corporate entity appear significant enough to discourage plaintiffs from invoking the doctrine against LLC members.
183. Although frequently litigated, veil-piercing is successfully argued in only forty percent of the cases. Thompson, supra note 73, at 1048.
184. In addition to the transactional cost (i.e., the inability of lawyers to advise their clients on how to properly arrange their transactions so as to avoid veil-piercing suits), another cost is associated with veil-piercing: the monetary costs of bringing and defending suits.
185. Practitioners will not know how to advise their clients because suits will be decided on a case-by-case basis. See Bainbridge, supra note 14, at 481.
PIERCING THE CORPORATE VEIL

limited liability empty. The problem highlighted here, however, is the impact it has on the growth of small businesses.

Although California intended to encourage the growth of small business within the state by enacting the BeverlyKillea Limited Liability Company Act, that Act's veil-piercing scheme hampers California's efforts by creating perverse incentives that potentially deprive those businesses of funding. First, it gives venture capital firms reason to not invest in small LLC businesses. Second, even if venture capitalists are willing to invest in LLCs, the veil-piercing doctrine gives investors reason to not invest in venture capital funds. Without adequate funds, venture capitalists cannot finance the LLCs.

IV. ANALYSIS

A. Problems with the Current System

The current position of the California legislature on veil-piercing in LLCs is not completely without merit, as the goals behind it are laudable. The second prong of the piercing analysis announced in Laya, the inequitable result, inherently suggests the praiseworthiness of the doctrine. However, that doctrine creates two incentives that justify its abolition.

1. Venture Capitalists' Incentive to Not Invest in LLCs

LLCs are suitable for venture capital investment. Until the check-the-box taxation system was introduced, LLCs may have been unattractive to venture capitalists because they could not take advantage of corporate characteristics such as continuity of life, centralized management, and free transferability of interests, and still qualify for partnership taxa-

187. BALLANTINE, supra note 10, § 900.02[5].
188. See discussion infra Part IV.A.
190. Venture capitalists fund many high-tech businesses, and the LLC form is appealing to many high-tech businesses. Callison, supra note 57, at 98 (listing reasons why the LLC form would be appealing to high-tech start-ups).
Those characteristics are important to venture capitalists and are allowable under the current tax regime.

Under the current system, however, venture capitalists have an incentive to forgo investing in smaller LLCs and instead invest in larger corporations. Currently, both LLCs and corporations utilize the doctrine of veil-piercing. Consequently, a venture capitalist investing in either will have to pay monitoring costs to ensure that the business behaves legally. The total amount spent monitoring depends on the number of companies invested in, not the amount invested per company. Therefore, venture capitalists will have an incentive to invest in fewer, but larger businesses, rather than in multiple smaller businesses, which frequently are LLCs. As a result, LLCs will find it more difficult to secure venture capital than will their larger corporate counterparts.

2. Investors' Incentive to Not Partner in Venture Capital Firms

Investors seeking to make large investments in businesses can do so directly by purchasing stock in several companies, or indirectly by joining as a limited partner in a venture capital firm that will, in turn, invest in several companies. The decision to make the investment directly or indirectly will turn on a number of factors, one of which includes the probability of veil-piercing.

191. Schwindt, supra note 57, at 1545-46 (noting that, practically speaking, in order to be classified as a partnership for tax purposes, two of the following factors must be absent: continuity of life, centralized management, and free transferability of interests).

192. Both continuity to life and free transferability of interest are central to the venture capitalist's desire to sell and exit its investment at the appropriate time.

193. Currently, the California State Board of Equalization and the Internal Revenue Service both allow LLCs to choose partnership taxation with a simple check in the appropriate box on the tax form. Compare CAL. REV. & TAX CODE § 28.5 (West 1998) (classifying LLCs as partnerships for tax purposes), and Treas. Reg. § 301.7701-3 (as amended in 2003).

194. CAL. CORP. CODE § 17101(b) (West Supp. 2005).

195. Monitoring costs are costs associated with ensuring that one's agent behaves properly. Callison, supra note 57, at 105.

196. See Bainbridge, supra note 14, at 491 ("The greater the degree of monitoring of each investment required, the fewer investments that will be made.").

197. See BALLANTINE, supra note 10, § 900.02[5].

198. Liability is a concern for venture capitalists. See GLADSTONE, supra note 147, at 326 (enumerating liability-related questions venture capitalists ask of lawyers before deciding to invest).
Veil-piercing plays a different role depending on which type of investment is made. Where investors elect to make the investment directly, each investment will be a discrete event (i.e., one investment will be independent of any other investment made). Where they invest by purchasing through a venture capital firm, each investment will have at least one aspect in common: they were all made through a venture capital firm.

Assuming that the investors intend on being passive investors, they will be better off by selecting the direct form of investment. The advantage of direct investing is that each investment is independent of all others. An investment in one company cannot destroy an investment in another, and therefore the investors' diversification strategies remain intact. The disadvantage of direct investing is that the investors open themselves up to unlimited personal liability if the veil of one of the companies is pierced. If they remain passive investors, however, that liability will be of nominal concern.

The decision to invest indirectly by partnering in a venture capital firm, however, draws exactly the opposite concerns. These investors have a drastically lower chance of being held personally liable, but have an increased possibility that, if veil-piercing occurs, one investment will affect all others. If one of the companies the venture capitalist invested in has its veil pierced, the investor's entire contribution into the venture capital firm may be used to satisfy the liability.

Additionally, veil-piercing is theoretically more likely to occur in venture capital investments. Venture capitalists tend to invest in non-public companies, a class of businesses particularly susceptible to veil-piercing. Also, they often

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199. Many of the factors stated in Laya that condition piercing of the veil will not be present where a shareholder owns stock in multiple companies, but does not exercise management control. See Laya, 352 S.E.2d at 98-99.

200. Veil-piercing is a concern for passive investors only when they behave improperly. See id. (listing impermissible shareholder acts that would condition piercing of the veil).

201. The investors in this case will have protection from the veil of the LLC, the corporation, or the limited partnership.

202. See Gevirtz, supra note 4, at 252 (speculating on whether a venture capitalist may be liable for more than its contribution into a company if that company's veil is pierced).

203. Venture capitalists invest in companies before they go public with the intention of taking them public. QUINDLEN, supra note 2, at 18.

204. Thompson, supra note 73, at 1047 (stating that veil-piercing does not
take an active role in the management of their investments,\footnote{Occur in publicly traded corporations).} which is a factor courts consider when deciding whether to pierce the veil.\footnote{Supporters of veil-piercing may contend that the existence of the doctrine makes no difference at all to the underlying investors (i.e., the limited partners) of a venture capitalist firm. They may point out that the limited partnership status of most venture capital firms already protects the underlying investors from personal liability and, therefore, whether the portfolio company offers an additional limited liability shield is inconsequential. Such reasoning would be wrong. Although the limited partners in a venture capital firm would not be personally liable even if the veil of the portfolio company were pierced, the shield at the LLC level offers protections different from those provided by the limited partnership shield. The LLC shield should ensure that the liability of one company cannot destroy the entire fund. The limited partnership’s shield does not cover the firm’s assets, it only covers the personal assets of the limited partners. Presumably, if a venture capital firm did not have enough liquid assets on hand to satisfy a judgment levied against it through the doctrine of veil-piercing, it would have to sell off its stake in another company to pay the judgment. Investors, thus, have an incentive to make several discrete investments, where no one investment can affect another, instead of a single investment into a venture capital firm, where one company invested in can destroy the entire investment.

\footnote{If investors are willing to invest so long as unlimited personal liability is not a possibility, then investors will not be discouraged from joining as a limited partner in a venture capital firm because unlimited liability is unlikely to be imposed because passive limited partners are generally immune from liability.}

\footnote{Limited partners in a limited partnership are generally only liable to the extent that they exercise control over the business. Investors who exercise no such control are generally immune from personal liability. Schwindt, supra note 57, at 1551.}

\footnote{The venture capitalists’ concept of having at least one firm achieve wealth sufficient to offset all the other losses is premised on the assumption that the venture capitalists’ loss due to an unsuccessful company will be limited to the amount of capital contributed to it.}
B. Policy Considerations in an Ideal LLC Liability System

The incentives created by the doctrine of veil-piercing may begin to justify abolition of the veil-piercing doctrine, but abolition should not occur unless an alternate system of liability can be devised which will better serve society’s interests. There are two primary considerations in determining whether this ideal system of LLC liability exists and is practicable. First, except in certain circumstances, it is important that someone be held accountable when a tort or breach of contract occurs. Second, it is important that the aggrieved party be redressed.

1. Accountability

Although it is usually important that someone be held accountable when a loss occurs, the removal of the veil-piercing doctrine does not exculpate all tortfeasors and contract breakers. Indeed, in most circumstances, the exact same persons will be held accountable whether or not veil-piercing is an option. In other situations, the absence of the doctrine may allow certain persons to escape liability where they otherwise would have been held accountable. This discrepancy, however, was seemingly the intent of the legislators in enacting the Beverly-Killea Limited Liability Company Act.

To determine whether abolition of the doctrine from LLC jurisprudence will alter the makeup of persons who may be held accountable, it is instructive to analyze the circumstances where courts have traditionally pierced the veil. Courts have generally imposed liability on shareholders (1) when there has been fraud, (2) when the corporation has failed to adhere to corporate formalities, (3) when shareholders

211. 9 Arthur Linton Corbin, Corbin on Contracts § 946 (interm ed., Matthew Bender 2002) (1951) (“For every breach of contract, irrespective of its size or kind, the law will give an immediate remedy.”).
212. Accountability is not always necessary. See discussion infra Part IV.B.1.a.
213. See generally Bainbridge, supra note 14.
214. See discussion infra Parts IV.B.1.b-d.
215. See discussion infra Parts IV.B.1.b-d.
ers have abused the corporate entity by exercising dominant control, and (4) where the corporation has been inadequately capitalized.216

a. Fraudulent and Tortious Acts

At the outset, it is important to note that it is not always important to ensure that plaintiffs have someone, other than the LLC itself, to hold accountable. This is true primarily where the plaintiff had the opportunity to investigate the defendant entity's assets before entering into contractual relations with it.217 Because LLCs are given the freedom to vary greatly in structure and form,218 it is a good practice for all contract parties to conduct an investigation of the LLC's structure, assets, and credit worthiness. If, upon examination, it is suspected that the LLC does not possess assets adequate to satisfy a judgment, the parties are free to walk away or contractually assign personal liability to the LLC members.219 If the contracting party fails to do so, it is fair to deem that that party assumed the risk that recovery would be limited to the LLC's assets.220

In all other cases (primarily those involving fraudulent or tortious acts), however, ensuring that culpable parties are held accountable is of greater importance because it is less likely that plaintiffs will be able to successfully investigate the defendant's assets. In cases involving fraud, asset investigation attempts may be thwarted due to the fact that fraudulent behavior is based on deception. In tort cases, investigation of the defendant's assets is difficult because the plaintiff often does not voluntarily deal with the defendant.221

217. See Bainbridge, supra note 14, at 502-03 (discussing the propriety of penalty defaults). This is also the rationale behind the third prong of Laya, 352 S.E.2d at 100.
218. BALLANTINE, supra note 10, § 900.02[4] (noting that the LLC statutes allow most statutory provisions to be overridden by either the articles or a written operating agreement).
220. In certain cases it would be unfair to allow a contract party to pierce the veil and recover money. For example, where the contract party already received a discounted price in the contract based on the understanding that no personal guarantee would be available.
221. The torts of assault, battery, false imprisonment, negligence, etc. often involve an unsuspecting victim.
Accountability is necessary in these circumstances not only because it gives victims a defendant from which they can seek relief, but also because it deters future acts of fraud and encourages precautionary measures against negligent tortious acts. Fortunately, even without veil-piercing, accountability can still be ensured.

If the veil-piercing doctrine is abolished and therefore unavailable in cases involving fraud or tort, the makeup of parties who may be held accountable would remain substantially the same. 222 This is true in large part because the limited liability shield does not protect LLC members who are sued on a theory of direct liability. 223 Under California Corporations Code section 17101, members are held liable for their personal actions. 224 Moreover, victims can hold the LLC itself accountable if the wrongdoer was acting within his role as the LLC's agent. 225 The absence of the doctrine will be felt primarily where a plaintiff seeks to hold a LLC member liable for a loss he did not directly cause. Excluding non-culpable parties and restricting plaintiffs to direct and agency liability is the proper limit of liability, whether the member who caused the wrongful act is from a member-managed or manager-managed LLC. The proper limit of liability is determined by balancing two competing social goals. On the one hand, liability must be imposed on members frequently enough such that they will be deterred from engaging in carefree entrepreneuring. On the other, liability should not be imposed so frequently that members will feel restrained from performing acts they are legitimately authorized to do.

To justify abolition of the veil-piercing doctrine, in both the member-managed and manager-managed contexts, an adequate threat of personal liability must be present to deter members from misbehaving. In both types of LLCs, an ade-

222. See generally Bainbridge, supra note 14 (arguing that the doctrine of veil-piercing is unnecessary because the same parties can be held accountable through direct and enterprise liability).

223. Id.; § 17101(c) (Liability shield should not “be construed to affect the liability of a member . . . (1) to third parties for the member’s participation in tortious conduct, or (2) pursuant to the terms of a written guarantee or other contractual obligation entered into by the member . . . .”); Schwindt, supra note 57, at 1548 (“If a member commits a tort while in the course of LLC business, she may be held personally liable for that tort.”).

224. § 17101.

225. See Callison, supra note 57, at 107.
quate threat exists because members can always be held personally liable for their own misconduct. Where a fiduciary duty exists, as in the member-managed context, an added threat exists: the threat of a second lawsuit. In addition to victim’s suit, a suit may be filed by the LLC against a managing member for breach of fiduciary duty if that member misbehaves and the LLC is held liable.

The threat of personal liability, however, should not be so cumbersome so as to prevent members from performing acts that are within their right. Where the member has not himself misbehaved, the member should not be held personally liable. Imposing personal liability for other members’ actions would cause members to act in a risk-averse manner. Often, acting in a risk-adverse manner is contrary to the company’s best interests since businesses often need to take bold risks to grow. This may be especially true for small businesses—the very business the LLC was intended to help.

One final matter must be addressed regarding the proper limit of accountability and the encouragement of investors. Bainbridge contends that the proper balance between encouraging investors and preventing corporate abuse can be struck by utilizing the theory of enterprise liability. Enterprise liability, Bainbridge explains, is similar to veil-piercing liabil-

226. § 17101(c).
227. Compare § 17150 (stating that members in a member-managed LLC have the same obligations as managers in a manager-managed LLC), and § 17153 (stating that managers have a fiduciary duty). Although managers in manager-managed LLCs also owe fiduciary duties and face the threat of a second lawsuit, the non-managing members do not owe such duties and, thus, will not be subject to the deterrent effect of a possible second lawsuit.
228. § 17153 (“The fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership.”).
229. 67 WALTER C. TUTHILL ET AL., LIMITED LIABILITY COMPANIES: LEGAL ASPECTS OF ORGANIZATION, OPERATION, AND DISSOLUTION A-25, A-26 (Bureau of Nat’l Affairs ed. 1999) (distinguishing members and managers’ liability to third parties from their liability to the LLC and stating “to the extent that the [operating] agreement sets forth fiduciary or other duties for members or managers, . . . members and managers may be liable to the LLC and its members for breach of such duties and standards”).
231. Small businesses often have to take greater risks to compensate for their inability to provide the reputation and stability that larger businesses can often provide.
232. BALLANTINE, supra note 10, § 900.02[5].
ity in that it allows plaintiffs to hold a parent corporation liable for the acts of a subsidiary corporation when the two corporations are improperly treated as one enterprise. Indeed, the entire enterprise can be held liable for each others’ acts. This liability is unlike veil-piercing liability, however, in that the individual investor who owns the entire enterprise cannot be held personally liable. The investor is protected because he is a natural person and, thus, cannot be part of the enterprise. Bainbridge concludes that this scheme of direct and enterprise liability creates the proper level of accountability because it allows plaintiffs to recover from investors’ entire investment into the group enterprise, but still limits the investor’s liability to his or her original contribution.

Bainbridge notes that enterprise liability is not the same as veil-piercing liability, but fails to state that enterprise liability suffers from many, although not all, of the drawbacks of traditional veil-piercing liability. Enterprise liability still threatens venture capitalists. It allows plaintiffs to recover from a venture capitalist’s entire fund since the venture capital firm is a limited partnership, and thus can be considered part of the enterprise. Because the enterprise invests as an individual investor would, the venture capital firm itself should be treated as an individual investor and should also be liable to each investment only to the amount it originally contributed to that single business. Enterprise liability, thus, holds too many parties accountable.

b. Formalities

Both the “failure to comply with formalities” and the “exercise of dominant control” reasons for piercing the veil are

234. Id. at 531.
235. Id.
236. Id. at 529.
237. Id.
238. Id. at 531.
239. Bainbridge’s proposal draws unwarranted distinctions between owners who are individuals and owners who are limited liability entities. See Bainbridge, supra note 14, at 531. As entities in their own right, even artificial entities deserve protection.
240. Under Bainbridge’s model, individual investors have their liability limited to amount they invested. Id.
241. This type of error punishes innocent conduct, which can cause investors to behave in a risk-averse manner.
not transferable to LLC jurisprudence,\textsuperscript{242} and therefore members need not be held accountable on these rationales.

Under California Corporations Code section 17101(b), LLCs need not comply with certain formalities.\textsuperscript{243} Thus, the requirement of adherence to corporate formalities cannot be directly transferred to LLC law.\textsuperscript{244}

c. The Exercise of Dominant Control

Whether LLC members exercising dominant control should be a reason to hold them accountable requires a deeper analysis.

In the corporate law context, the dominant control factor has been one of the most determinative in courts' decisions on whether to pierce the veil.\textsuperscript{245} The importance of this factor relative to others can be demonstrated with the statistics gathered in Professor Thompson's study.\textsuperscript{246} Prior to the study, many analysts believed that whether a plaintiff had an opportunity to investigate a corporate defendant's assets, and whether a plaintiff voluntarily formed a relationship with a corporate defendant, would be two factors courts would weigh heavily when deciding whether the corporate veil should be pierced.\textsuperscript{247} Accordingly, these analysts believed tort claimants had a greater claim to piercing than claimants who alleged breach of contract.\textsuperscript{248} Contract claimants could have chosen not to transact with the corporation and had a greater opportunity to evaluate its assets.\textsuperscript{249}

Thompson's study, however, found that courts have disregarded \textit{Laya}'s third prong of analysis and have pierced the veil more readily in breach of contract cases than in tort.\textsuperscript{250} This finding suggests that the determinative factors in veil-
piercing cases are those relevant to defendant's conduct, not the victim's.\textsuperscript{251} Thus, one can conclude that shareholders are normally protected by virtue of their being passive, and not because of anything the plaintiff did or did not do.

Although the actions of corporate shareholders may weigh heavily on courts' decisions of whether the shareholder should be held personally liable, the "exercise of dominant control" factor should often be immaterial in determining whether an LLC member should be held personally liable. Proponents of veil-piercing have compared LLC members' poorly made decisions with shareholder decisions that warrant piercing of the corporate veil.\textsuperscript{252} At least in the member-managed context, this comparison is unwarranted.

The actions of members cannot be compared to those of shareholders. While shareholders are prohibited from exercising control over the corporation,\textsuperscript{253} LLC members in a member-managed LLC are given statutory authority to legally bind the LLC.\textsuperscript{254} Arguably, it is not the active nature of managing shareholders that condition their liability, it is the unauthorized nature of that management.\textsuperscript{255} In corporations, liability reaches the assets of shareholders only when they exercise control over the corporation.\textsuperscript{256} Since shareholders are not vested with management rights,\textsuperscript{257} they are held responsible for the harm caused by their disobedience. There can be no such disobedience in the LLC context, where mem-

\textsuperscript{251} Four of the most frequently cited factors during piercing are: fraud, failure to adhere to formalities, exercise of control by shareholders and inadequate capitalization—all of which focus on the defendant. Cohen, supra note 186, at 456.

\textsuperscript{252} Schwindt, supra note 57, at 1559 ("Member management can be analogized to shareholders who serve as directors in a corporation.").

\textsuperscript{253} CAL. CORP. CODE § 300 (West 1990) ("[A]ll corporate powers shall be exercised by or under the direction of the board.").

\textsuperscript{254} CAL. CORP. CODE § 17150 (West Supp. 2005) ("[T]he business and affairs of a limited liability company shall be managed by the members . . . ").

\textsuperscript{255} Because piercing always occurs in the corporate context when two factors are present (shareholders exercising control and that control being unauthorized), it is difficult to determine which factor motivates the court in its determination. In the LLC context, both factors need not be present simultaneously since the exercise of control is permitted by statute.

\textsuperscript{256} In cases where courts have chosen to pierce the corporate veil, the defendant was using the corporation as an alter ego approximately 96% of the cases. Thompson, supra note 73, at 1063.

\textsuperscript{257} CAL. CORP. CODE § 300 (West 1990).
bers are permitted to act on behalf of the entity.\textsuperscript{258} Thus, application of the doctrine is inappropriate.\textsuperscript{259} To hold members liable for their actions would make the limited liability promise empty.\textsuperscript{260}

In manager-managed LLCs, members should not exercise dominant control. Where a member does, he should be held accountable for his actions. In this circumstance, the member can be held accountable under the theory of direct liability.

d. Inadequate Capitalization

Inadequate capitalization under the current liability scheme cannot be a basis for liability because the Beverly-Killea LLC Act allows LLCs to be formed without any current capital.\textsuperscript{261} Unless this allowance is changed, members should not be held liable because the LLC is undercapitalized.

Besides serving as a factor in the determination of the proper parties to be held accountable, the inadequate capitalization factor is closely linked with the issue of ensuring that victimized parties will be adequately redressed.

2. Redressability

For a class of business entities to succeed in a world that is dependent on contracts, it must be able to provide enough assurance such that other businesses will feel secure con-
tracting with it.\textsuperscript{262} Such assurance occurs when the contracting partner knows not only that someone will be held accountable in event of a breach, but also that its loss will be redressed.\textsuperscript{263}

The doctrine of veil-piercing in the corporate setting is argued when the defendant corporation has insufficient assets to satisfy a judgment levied against it.\textsuperscript{264} Where no direct liability against a member or manager is possible and only the LLC entity itself is held liable, it is imperative that the LLC remain adequately capitalized at all times so that redress is guaranteed.\textsuperscript{265} Not surprisingly, adequate capitalization is a major factor courts consider when piercing the corporate veil.\textsuperscript{266}

Under the Beverly-Killea LLC Act, adequate capitalization is far from assured. Unlike the statute for corporations,\textsuperscript{267} section 17200(a) allows membership interests in an LLC to be issued without any capital contribution.\textsuperscript{268} Although basic contract law requires some consideration be paid before the member’s rights become enforceable,\textsuperscript{269} any amount is generally sufficient,\textsuperscript{270} even if it falls short of an amount necessary to redress tort victims and parties injured by a LLC’s breach of contract. Once the LLC has been adequately capitalized it is important that the LLC maintains assets in an amount that can cover any losses it causes so that parties can be redressed.

\begin{itemize}
\item \textsuperscript{262} An exception to this proposition is businesses willing to take greater risks for larger rewards. Thompson, \textit{supra} note 73, at 1039-40 (discussing risk-bearers who lend credit for a higher fee).
\item \textsuperscript{263} For this reason, many businesses require their contract parties to show proof of insurance.
\item \textsuperscript{264} Where a corporation has assets sufficient to satisfy judgments levied against it, plaintiffs have no need to pursue veil-piercing.
\item \textsuperscript{265} 9 CORBIN, \textit{supra} note 211, § 946 (“For every breach of contract, irrespective of its size or kind, the law will give an immediate remedy.”).
\item \textsuperscript{266} Adequate capitalization is a factor in 73% of all piercings. Thompson, \textit{supra} note 73, at 1064.
\item \textsuperscript{267} California Corporation Code section 409 requires actual receipt of capital for issuance of corporate stock. \textsc{Cal. Corp. Code} § 409 (West 1990).
\item \textsuperscript{268} \textsc{Cal. Corp. Code} § 17200(a) (West Supp. 2005). The language is permissive. \textsc{Marsh et al.}, \textit{supra} note 97, § 3.05[D][1][a].
\item \textsuperscript{269} A contract requires valid consideration to be enforceable. 2 JOSEPH M. PERILLO & HELEN HADJIYANNAKIS BENDER, \textsc{Corbin on Contracts} § 5.2 (rev. ed. 1995).
\item \textsuperscript{270} The requirement for consideration in forming a contract can be satisfied by a nominal sum so long as the amount was bargained for. \textit{Id.} § 5.17.
\end{itemize}
In certain situations, monitoring the maintenance of adequate funds becomes administratively too difficult, or the amount at risk becomes so high that society's interests are best guaranteed by more than an entity's assets or by a personal liability guarantee. Often, this latter problem does not affect LLCs because several of the businesses which are more prone to lawsuits or which deal with large sums of money have been statutorily prohibited from organizing as LLC entities.

V. PROPOSAL

Importing the common law veil-piercing doctrine from corporate law into LLC law saves judges and law practitioners from the uncertainty of wondering if and how veil-piercing will play a part in member or manager liability. Although that justification is laudable, the same goals of veil-piercing can be achieved through an alternative method that is both true to the limited liability concept and consistent with California's interests.

Rather than including the veil-piercing doctrine within the LLC statute, the doctrine should be eliminated. Third party interests can and should be protected through adequate capitalization of the LLC and the direct liability of those directly responsible for the loss. Tort victims and contract breachees should look toward the LLC entity for accountability and redress for the LLC's actions. If a member acted without authorization in a manner that caused loss, then the plaintiff can look to that member and impose liability directly, not through the veil-piercing doctrine.

Adequate capitalization can be monitored by the Secretary of State when the LLC organizer files the articles of or-

271. The medical profession exemplifies a field where it is too difficult to monitor "adequate" funds. The amount that is "adequate" varies doctor by doctor and it is inherently difficult to associate a value with medical malpractice.
272. Some businesses, such as banks, deal with sums of money that shift so frequently it is difficult to monitor what constitutes an "adequate" amount.
274. California sought to encourage the growth of small businesses with the enactment of the Beverly-Killea LLC Act. BALLANTINE, supra note 10, § 900.02[5].
275. Schwindt, supra note 57, at 1548 (stating the LLC form does not allow members to escape their personal conduct).
ganization. Section 17200 of the Beverly-Killea LLC Act can be amended to require the aggregate of members to satisfy minimum contribution amounts that will guarantee satisfaction of any liabilities that may potentially accrue to businesses in the applicant's industry. Moreover, that section can be amended to require the organizer to submit a plan by which the aggregate of the members will make additional commitments into the LLC capital as the business grows and the potentiality of greater liabilities increases. The contribution can be a withheld portion of the member's financial return or a promise to make additional payments. The requirement of adequate initial capitalization is already a corporate requirement, but the requirement of future contributions is an easy addition unique to LLC law because it can be enforced alongside the existing LLC provision that allows the investor to gain membership interest by contributing future services (or capital). This addition is simply an implementation of an existing LLC provision that allows members to make contributions contingent on the occurrence of a specified event. Under this recommendation, the contingency is the growth of the LLC. Contingent contributions cannot be recovered by third parties if the specified event fails to occur.

This system can ensure redress to victims of a LLC's wrongdoings. Promises to contribute capital are binding on the member and can be enforced by third parties against the member's personal assets if the LLC's assets are insufficient. Although the proposal to hold members personally responsible for commitments to capitalize when loss beyond the company's assets occurs may sound like a restatement of the current veil-piercing doctrine, it differs because it is actually a subset of the liability that could be imposed under the current system. The liability would only be for a well-defined (i.e., limited) amount and may be called upon in only well-

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277. Provisions for additional contributions are authorized under the current code, but the use of such agreements is permissive, not mandatory. Id. § 17200. A formula to calculate the exact amount of future contributions requires economic considerations beyond the scope of this comment.
278. Id.
279. MARSH ET AL., supra note 97, § 3.05[D][1][d].
280. § 17201(c).
281. Creditors have the right to enforce commitments under section 17201.
defined circumstances.

The policy behind this system is in line with California's interests. First, this system redresses victims for their losses and holds the proper party accountable. Where venture-backed companies are held liable, redress is particularly likely because the amount necessary to make the victim whole will likely fall within the company's net worth. Second, the at-fault party is liable for the proper amount and thus, investments are not discouraged. If unlimited personal liability were a possibility for members whenever LLCs incur liability, this factor would discourage investors from funding businesses that are vital to California's economy. Third, the system brings predictability into the liability scheme. The uncertainty of liability is especially true in the corporate context where the factors that prompt courts to pierce are particularly nebulous.

VI. CONCLUSION

California courts have been using the judicial doctrine of piercing the corporate veil since 1921. The veil-piercing doctrine began as an exception to the rule, but has since taken a life of its own and has become the most litigated issue in corporate law. It has been argued in cases where it has no place, yet it has been embodied in LLC law by the Beverly-Killea LLC Act. Despite the attributes that corporations and LLCs share, the doctrine of veil-piercing has no place in LLC law because the entities differ and interests in California are best served by preserving the limited liability nature of LLCs. By protecting society's well-being against an LLC's misconduct through adequate capitalization, California can create a more stable body of law that is both predictable and reliable. These characteristics foster the funding of California businesses through venture capital funds. California has progressed greatly by encouraging venture-backed companies.

282. Recent venture capitalist commitments have exceeded the average awards in tort cases. According to a 1999 study, median compensatory damages were $50,000 and median punitive damages were $200,000. See Ted Rohrlich, We Aren't Seeing You in Court, L.A. TIMES, Feb. 1, 2001, at A1, A17.
283. Schwindt, supra note 57, at 1556.
285. Thompson, supra note 73, at 1036.
286. CAL. CORP. CODE § 17101(b) (West Supp. 2005).
That progress can be continued without injury to the safety of society, but for it to do so, the California legislature must put to rest the doctrine of LLC veil-piercing and allow the LLC to truly take on a limited liability status.