CONSTITUTIONALLY MANDATED FAIRNESS AND THE LIMITED LIABILITY COMPANY: AN ARGUMENT FOR THE EXTRA-TERRITORIAL APPLICATION OF LIMITED LIABILITY COMPANY STATUTES

INTRODUCTION

The limited liability company (LLC) is a business form that combines the limited liability of a corporation with the pass-through tax status characteristic of the general partnership, limited partnership, and S corporation.[1] Questions about the LLC's tax status formerly limited its business practicability, but in 1988, the Internal Revenue Service (IRS) ruled that a Wyoming LLC would be considered a partnership for tax purposes.[2] This favorable ruling by the IRS has combined with other factors to generate a renewed interest in the LLC.[3] One area of uncertainty still restricting the LLC's business practicability, however, is whether limited liability will be retained by LLC members if the firm engages in business activity in a state having no statutory provision for the formation or regulation of LLCs.

Previous analysis suggests that there are no constitutional or conflict of laws constraints which would preclude a state that has not recognized the LLC from disregarding the limited liability of its members.[4] Because no court has addressed the limited liability issue with respect to LLCs, however, courts are free to adopt any rule they choose. This comment provides a normative analytical framework that courts may wish to consider in determining whether to recognize the limited liability of LLC members.

Part I surveys the literature examining LLC member liability outside the state of formation. Part II begins the analysis by consider-

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[1] In-depth analysis of the business and tax advantages which the LLC possesses over other business forms is beyond the scope of this article. For such an analysis, see Robert A. Keatinge *et al.*, *The Limited Liability Company, A Study of the Emerging Entity*, 47 BUS. LAW. 378 (1992) [hereinafter Keatinge]; Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387 (1991); Susan P. Hamill, *The Limited Liability Company: A Possible Choice for Doing Business*, 41 FLA. L. REV. 721 (1989).

[2] Rev. Rul. 88-76, 1988-2 C.B. 360.

[3] Among these factors were changes in the tax code favoring pass-through entities along with concerns among small business owners about unlimited liability. *See* Keatinge *supra* note 1, at 378. Prior to 1990, LLCs had been allowed in only two states. The above factors have resulted in the adoption of LLC statutes in six states and their consideration in eighteen more. *Id.*

[4] *See* Keatinge, *supra* note 1, at 442-56; Gazur & Goff, *supra* note 1, at 427-437.

ing whether LLC members should have an entitlement to limited liability arising from the Due Process and Full Faith and Credit Clauses. Part III considers whether LLC members should also have an entitlement to limited liability arising from the Commerce Clause. Part IV concludes the analysis, arguing that courts should view LLC member liability as a matter of private contract between LLC members and those who choose to do business with the LLC and that states should limit their intervention in such agreements to enforcing the ex ante expectations of the parties.

I. BACKGROUND

Thus far, the issue of whether limited liability accrues to LLC members whose LLC conducts business in a state with no provision for LLCs has received limited academic treatment.[5] According to this work, LLCs have the constitutional right to conduct business outside the state of formation, based upon the Commerce Clause, but this right must be weighed against the state's interest in regulating the intrastate activities of a foreign business entity.[6] The analysis also suggests that an LLC desiring to do business outside the state in which it is formed should attempt to register in the state where it wishes to do business,[7] and if the state in question has no statutory provision for the registration of foreign LLCs, the LLC should probably register as a foreign corporation.[8] An LLC's failure to qualify to do business in a given state would not necessarily mean that its members will be stripped of their limited liability; nonetheless, there is a possibility that a court would

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[5] *See* Keatinge, *supra* note 1; Gazur & Goff, *supra* note 1.

[6] *See* Keatinge, *supra* note 1, at 447-48; Gazur & Goff, *supra* note 1, at 430-431. Gazur and Goff point out that even if a state has the absolute right to bar the entry of foreign entities, this right still might not apply to a foreign entity engaged solely in interstate commerce. *Id.*

[7] All LLC statutes presently in effect authorize the LLC to conduct interstate and foreign business. *See* Keatinge, *supra* note 1, at 447. These statutory allowances provide the requisite statutory authority allowing the LLC to apply for authorization to do business in other jurisdictions. *See* Gazur & Goff, *supra* note 1, at 428. Registration of the LLC in a foreign jurisdiction affords protection through the state's official recognition of the LLC as a foreign entity licensed to do business in that state, and it avoids any state-imposed penalties arising from the failure to register. *See id.* at 429-430.

[8] Six of eight states that allow LLCs also have statutory provisions for registering foreign LLCs, and one other state, while not permitting the formation of domestic LLCs, allows for the registration of foreign LLCs. *See* Keatinge, *supra* note 1, at 448. LLCs attempting to register in other states are more likely to qualify to do business as a corporation rather than as limited partnership, because limited partnership statutes require the presence of at least one general partner who is liable for all of the LLC's obligations. *See* Gazur & Goff, *supra* note 1, at 428-429.

recharacterize the LLC as a general partnership, thus subjecting LLC members to liability for the firm's debts.[9]

Much of the analysis on LLC member liability focuses upon conflict-of-laws and comity issues that a court would need to consider in addressing this question. In a state with no statutory provision for the formation or regulation of LLCs, the issue of member liability would most likely arise where a cause of action against the LLC originated in such a state. That state's courts, therefore, would have to decide whether to recognize the limited liability of LLC members through the use of general choice-of-law-principles.[10]

In analyzing these choice of law principles, commentators emphasize that common law comity[11] would not preclude courts in the forum state from ignoring the limited liability of LLC members. To the extent that the LLC can be analogized to a foreign corporation, Gazur and Goff conclude that comity would never be extended "where. . . [the] corporation's existence in the state or the exercise of its powers there would be prejudicial to the state's interests or repugnant to its declared policy."[12] Additionally, the academic analysis identifies case law that is potentially applicable to LLCs where courts construing the rights of interest holders in a foreign business trust held that a contractual right to limited liability is not enforceable if this right would contravene the established public policy of the forum state, "even though such contracts are valid where made."[13] Commentators are similarly pessimistic about whether the principles embodied in the Restatement (Second) of Conflict of Laws would require a state to recognize the limited liability of foreign LLC members. If the forum state has no statute speaking to the member liability issue, section 6(2) of the Restatement directs a court to look at a number of factors in choosing the applicable law.[14]

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[9] *See* Keatinge, *supra* note 1, at 449. Keatinge points out that "principles of equity and public policy demand that a state that statutorily requires qualification procedures for foreign LLCs should respect the single most important corporate element of LLCs — limited member liability." *See id.* at 448.

[10] *See* Gazur & Goff, *supra* note 1, at 431.

[11] Comity is defined as "courtesy; complaisance; respect; a [court's] willingness. . . [to] give effect to laws and judicial decisions of another state or jurisdiction, not as a matter of obligation, but out of deference and mutual respect." BLACK'S LAW DICTIONARY 267 (6th ed. 1990) (citation omitted); *See* Keatinge, *supra* note 1, at 453.

[12] Gazur & Goff, *supra* note 1, at 433 (quoting 17 WILLIAM M. FLETCHER, CYCLOPEDIA OF THE LAW ON PRIVATE CORPORATIONS, § 8334 (rev. perm. ed. 1987) (citing Hall v. Woods, 156 N.E. 258 (Ill. 1927))).

[13] Keatinge, *supra* note 1, at 453-54 (quoting Means v. Limpia Royalties, 115 S.W.2d 468, 475 (Tex. Civ. App. 1938)). *See also* Gazur & Goff, *supra* note 1, at 433.

[14] These factors are:

The fact that the Restatement does not specifically provide for LLCs, however, makes it necessary to analogize the LLC to either a foreign corporation or limited partnership.[15]

With respect to the rights of a foreign corporation, the Restatement provides that incorporation in one state will be recognized by other states,[16] that the extent of a shareholder's liability is determined by reference to the laws of the state of incorporation,[17] and that other internal matters of the corporation will be governed by the laws of the incorporating state unless another state has a more significant interest.[18]

With respect to the rights of a foreign limited partnership, the Restatement provides that the local law of the state selected by application of the rules contained in section 6 will apply,[19] and that the relationship of a limited partner to his limited partnership is comparable to that of a shareholder to his corporation.[20] Despite this provision, however, commentators observe that if the LLC is analogized to a limited partnership, the Restatement allows the forum state much greater latitude in construing the rights of the LLC members than if the LLC was analogized to a corporation.[21]

Even if comity and choice-of-law considerations definitively indicate that forum states should honor the limited liability of foreign LLC members, however, reliance on these considerations would be of limited value, because of the Supreme Court ruling in *Allstate Insurance v. Hague*,[22] which allows forum states considerable leeway in applying their own law in choice-of-law situations.[23] Because of its potential im-

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(a) the needs of the interstate and international systems, (b) the relevant policies of the forum, (c) the relevant policies of other interested states and the relevant interest of those states in the determination of the particular issue, (d) the protection of justified expectations, (e) the basic policies underlying the particular field of the law, (f) certainty, predictability, and uniformity of result, and (g) ease in determination and application of the law to be applied.

RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6(2) (1971). *See* Keatinge, *supra* note 1, at 451-53.

[15] *See* Keatinge, *supra* note 1, at 452; Gazur & Goff, *supra* note 1, at 431-432.

[16] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 297 (1971).

[17] *Id.* § 307.

[18] *Id.* § 302. *See also* Keatinge, *supra* note 1, at 452; Gazur & Goff, *supra* note 1, at 431-432.

[19] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 295 (1971).

[20] *Id.* comment d. *See also* Keatinge, *supra* note 1, at 452.

[21] *See* Keatinge, *supra* note 1, at 452; Gazur & Goff, *supra* note 1, at 432.

[22] 449 U.S. 302 (1981).

[23] *See* Keatinge, *supra* note 1, at 454-55; Gazur & Goff, *supra* note 1, 435-436.

portance to the LLC issue, the analysis will begin with an examination of the Court's decision in *Hague*, and its application to LLC member liability.

II. DUE PROCESS, FULL FAITH AND CREDIT, AND THE LLC

In *Allstate Insurance Company v. Hague*,[24] the Supreme Court addressed the extent to which the Due Process Clause[25] and the Full Faith and Credit Clause[26] could constrain a state court's choice of law determination. A plurality of the Court held that a Minnesota court's application of Minnesota law to an automobile accident that occurred in Wisconsin was "neither arbitrary nor fundamentally unfair" and therefore, did not violate the Due Process Clause or the Full Faith and Credit Clause.[27] An analysis of *Hague*, however, indicates that the Court's opinion should not be controlling in determining whether due process and full faith and credit considerations should limit a state's ability to impose unlimited liability upon the members of a foreign LLC.

To properly evaluate *Hague*, it is first necessary to review the facts of the case. In *Hague*, the plaintiff's husband died when an automobile struck the motorcycle on which he was a passenger.[28] Although the decedent worked in Minnesota, he was a resident of Wisconsin, as were the operators of both the motorcycle and the automobile involved in the crash.[29] The accident occurred in Wisconsin, not far from the Minnesota border.[30] Neither vehicle operator had insurance, but the decedent had a policy issued by the defendant Allstate Insurance Co., covering three vehicles that he owned which provided coverage for losses incurred in accidents with uninsured motorists in the amount of $15,000 per vehicle.[31] After her husband's death, the plaintiff moved to Minnesota and sued the defendant, asking that the uninsured motorist coverage on each of her husband's three automobiles be "stacked" in accor-

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[24] 449 U.S. 302 (1981).

[25] Section One of the Fourteenth Amendment states, in part, that no state shall "deprive any person of life, liberty, or property, without due process of law." U.S. CONST. amend. XIV, § 1.

[26] Article Four, Section One states that "Full Faith and Credit shall be given in each state to the public Acts, Records, and judicial Proceedings of every other state." *Id.* art. IV, § 1.

[27] Allstate Ins. v. Hague, 449 U.S. 302, 320 (1981) (plurality opinion).

[28] *Id.* at 305.

[29] *Id.*

[30] *Id.*

[31] *Id.*

dance with Minnesota law to provide total coverage of $45,000.[32] The defendant argued that the issue of whether the uninsured motorist coverage in the policy could be stacked should be determined by Wisconsin law, because the insurance policy was delivered in Wisconsin, the accident occurred in Wisconsin, and all the persons involved were Wisconsin residents at the time of the accident.[33] Both the Minnesota District Court and the Minnesota Supreme Court, after interpreting Wisconsin's law to prohibit the stacking of insurance coverage, disagreed with Allstate's argument, holding that the better rule of law favored selection of Minnesota's law on public policy grounds.[34]

The Court confined its review solely to determining whether the Minnesota Supreme Court's application of Minnesota substantive law exceeded federal constitutional limitations.[35] Despite broad agreement on limiting the nature of the Court's review solely to constitutional issues, the members of the Court could not agree on a method by which to apply the Due Process and Full Faith and Credit Clauses to the issue at hand. The plurality opinion chose not to distinguish between the two clauses in their application:

> In deciding constitutional choice-of-law questions, whether under the Due Process Clause or the Full Faith and Credit Clause, this Court has traditionally examined the contacts of the State, whose law was applied, with the parties and with the occurrence or transaction giving rise to the litigation. . . . In order to ensure that the choice of law is neither arbitrary nor fundamentally unfair, . . . the Court has invalidated the choice of law of a State which has no significant contact or significant aggregation of contacts, creating state interests, with the parties and the occurrence or the transaction.[36]

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[32] *Id.*

[33] *Id.*

[34] *Id.* at 307. The Minnesota Supreme Court, in asserting that stacking provided the better rule of law, pointed out that stacking would contribute to the Minnesota legislature's adopted policy of seeking to compensate accident victims to the full extent of their injuries, because it required "the costs of accidents with uninsured motorists to be spread more broadly through insurance premiums . . . [than would a non-stacking rule]." *Id.*; Hague v. Allstate Insurance Co., 289 N.W.2d 43, 49 (1979).

[35] *Hague*, 449 U.S. 302 at 307 (plurality opinion). The Court's decision was announced by a plurality of Justices Brennan, White, Marshall, and Blackmun. *Id.* at 304. Justice Stevens issued a concurring opinion, *id.* at 320, and Justice Powell, joined by Justice Rehnquist and Chief Justice Burger issued a dissenting opinion. *Id.* at 332. All three opinions agreed that the Court should limit its review to examining whether the choice of law was precluded by the Due Process Clause and the Full Faith and Credit Clause and that, absent a constitutional prohibition, the soundness of the Minnesota court's conflict of laws decision could not be examined. *Id.* at 307 n. 6 (plurality opinion); *id.* at 331-32 (Stevens, J., concurring); *id.* at 332 (Powell, J., dissenting).

[36] *Id.* at 308.

In applying this analytical framework to the Minnesota court's decision, the plurality reasoned that "Minnesota had a significant aggregation . . . of contacts with the parties and the occurrence, creating state interests, such that application of its law was neither arbitrary nor fundamentally unfair."[37] In contrast to the plurality's approach, in his concurring opinion, Justice Stevens distinguished between application of the Due Process and Full Faith and Credit Clauses:

> As I view this unusual case—in which neither precedent nor constitutional language provides sure guidance—two separate questions must be answered. First, does the Full Faith and Credit Clause . . . require Minnesota, the forum state to apply Wisconsin law? Second, does the Due Process Clause . . . prevent Minnesota from applying its own law? The first inquiry implicates the federal interest in ensuring that Minnesota respect the sovereignty of the state of Wisconsin; the second implicates the litigants' interest in a fair adjudication of their rights. . . .
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> I realize that both this Court's analysis of choice-of-law questions . . . and scholarly criticism of those decisions . . . have treated these two inquiries as though they were indistinguishable. . . . Nevertheless, I am persuaded that the two constitutional provisions protect different interests and that proper analysis requires separate consideration of each.[38]

Finally, while the dissent embraced the plurality's method of constitutional analysis, it characterized the contacts between Minnesota and the litigants as "trivial"[39] and maintained that "[n]either taken separately nor in the aggregate do the contacts asserted by the plurality today indicate that Minnesota's application of its substantive rule in this case will further any legitimate state interest."[40]

The fact that the Court both could not agree on a test for analyzing constitutional limitations to a forum state's choice of law and reached different results in applying the test used by the plurality, suggests a number of reasons why *Hague* may not apply to the LLC member liability issue. First, it is unclear whether the plurality's opinion will be followed in future cases.[41] While the plurality and concurring opinion comprise the views of five justices out of nine, Justice Stevens's

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[37] *Id.* at 320.

[38] *Id.* at 320-322 (Stevens, J., concurring).

[39] *Id.* at 332 (Powell, J., dissenting).

[40] *Id.* at 339.

[41] *See, e.g.*, CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987) (declining to apply Court decisions which did not reflect a majority of the Court's members).

approach to the constitutional questions posed is analytically dissimilar to that of the plurality. This dissimilarity, along with the considerable change within the Court's membership since 1981, calls into question whether the Court will consider itself bound by this decision in the future. *Hague* has also been subjected to considerable academic criticism on the grounds that the plurality's fundamental fairness test fails to adequately prevent a court from applying its own law to the detriment of other interests.[42]

Aside from general criticism of *Hague*, it is possible to pick out specific concepts which the Court used to reach its decision that militate against applying this result to the problem of LLC member liability. First, the plurality noted that while the method of practical application of the Due Process and Full Faith and Credit Clauses are identical, "[d]ifferent considerations are . . . at issue when full faith and credit is to be accorded to acts, records, and proceedings outside the choice-of-law area, such as in the case of sister state-court judgments."[43] This suggests that a state court's decision outside the choice-of-law area might be subjected to a stricter standard of review under the Full Faith and Credit Clause, and that this standard might involve a balancing of the forum state's interests with the interests of other states.[44] If so, this strongly suggests that a state court construing the liability of a foreign LLC member could not ignore the vested interest that an LLC member has in the limited liability provisions contained in the statute authorizing creation of the LLC.[45]

The second reason that *Hague* should not apply to the LLC member liability issue is that in applying the plurality's fundamental fairness test, the considerations that allowed the plurality to apply the stacking law to the detriment of Allstate would not apply in a suit against a foreign LLC. In *Hague*, the plurality reasoned that because Allstate did business in Minnesota as well as Wisconsin and knew that

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[42] *See* Russell J. Weintraub, *Who's Afraid of Constitutional Limitations on Choice of Law?*, 10 HOFSTRA L.REV. 17 (1981); Arthur T. von Mehren & Donald T. Trautmen, *Constitutional Control of Choice of Law: Some Reflections on Hague*, 10 HOFSTRA L.REV. 35 (1981); Linda Silberman, *Can the State of Minnesota Bind the Nation? Federal Choice-of-Law Constraints After Allstate Insurance Co. v. Hague*, 10 HOFSTRA L.REV. 103 (1981); James A. Martin, *The Constitution and Legislative Jurisdiction*, 10 HOFSTRA L.REV. 133 (1981).

[43] Allstate Ins. v. Hague, 449 U.S. 302, 308 (1981) (plurality opinion).

[44] *See id.*

[45] In all of the states which allow LLCs, specific statutory provisions explicitly state that members cannot be held liable for the LLC's debts and that a member is not a proper party to a proceeding by or against an LLC unless the object of the proceeding is to enforce a member's right against or liability to the company. *See* Keatinge, *supra* note 1, at 412-13.

the decedent worked in Minnesota, Allstate should have known that it might be held liable under the laws of Minnesota.[46] In contrast to *Hague*, LLC members have a substantial expectation that they will receive limited liability with respect to their dealings with the LLC. Indeed, it is the combination of limited liability and flow-through tax status that renders the LLC an attractive business form; without limited liability, there would be no reason to form an LLC. Given this expectation on the part of LLC members, it seems clear that even the fundamental fairness test used by the plurality in *Hague* would call into question on constitutional grounds a court's imposition of unlimited liability upon LLC members. In his concurring opinion, Justice Stevens opined that historically, the Court's application of the Due Process Clause to choice-of-law decisions has been concerned primarily with preventing unfair surprise to either litigant,[47] additionally demonstrating that the limited liability of LLC members outside the state of formation is not readily analogous to the liability of the defendant Allstate under Minnesota law.

While *Hague* is not fully apposite to the issue of LLC member liability, another line of cases that has not yet been overruled is squarely on point.[48] In the most recent of these cases, *Order of Commercial Travelers v. Wolfe*,[49] the plaintiff sought to sue a fraternal benefit society incorporated in Ohio for death benefits due under an insurance policy issued by the society. At issue in *Commercial Travelers* was whether the Full Faith and Credit clause required a South Dakota court to recognize a contractual provision in the policy, valid under the laws of Ohio, that limited the time in which any action may be brought under the policy to a period of six months after the society had denied the claim.[50] The plaintiff sought the application of South Dakota law, both because the South Dakota statute of limitations was six years, and because South Dakota had enacted a statute declaring void any contractual stipulation limiting the time under which a party may enforce his contractual rights.[51] The Court held that the South

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[46] Allstate Ins. v. Hague, 449 U.S. 302, 318 n.24 (plurality opinion).

[47] *Id.* at 327 (Stevens, J., concurring).

[48] While Gazur and Goff have pointed out that these cases may no longer be good law in the wake of *Hague*, Gazur & Goff, *supra* note 1, at 435-436, this does not detract from their value in a normative analysis, particularly with respect to their ability to clarify the Court's ambiguous position in *Hague*. *See* Martin, *supra* note 42, at 147-148 (asking for a "majority case with clearer rules, and perhaps even a case that does not involve an insurance company.").

[49] 331 U.S. 586 (1947).

[50] *Id.* at 588-89.

[51] *Id.*

Dakota court was required to recognize the laws of Ohio, reasoning that such recognition was necessary to ensure uniformity of the rights and obligations of all the society's members throughout the country.[52]

The applicability of *Commercial Travelers* to the issue of LLC member liability is that, much like corporation shareholders and benefit society members, LLC members are dependent upon the formation state's LLC statute to define their relationship to the LLC. It follows that they have an interest in having their relationship to the LLC uniformly defined regardless of the state in which they do business, in the same manner that a fraternal benefit society is entitled to have its relationship with its members uniformly defined.

III. INTERSTATE COMMERCE AND THE LLC

In analyzing whether the Commerce Clause[53] can be construed to restrict a state's ability to hold LLC members liable for the LLC's obligations, because Congress has enacted no legislation relating to or regulating LLCs, only the dormant power of the Commerce Clause to restrict a state's interference with interstate commerce is applicable in this case.[54] In recent years, the Supreme Court has typically evaluated dormant Commerce Clause questions through the use of a test which balances the state's interest in regulation affecting interstate commerce with that regulation's impact upon interstate commerce.[55] This balancing test has been subjected to considerable academic criticism.[56] In *CTS Corp. v. Dynamics Corp. of America*,[57] the Court refined its ap-

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[52] *Id.* at 592.

[53] U.S. CONST. art. I, § 8.

[54] *See* Willson v. The Black Bird Creek Marsh Co. 27 U.S. (2 Pet.) 245 (1829) (holding that state's exercise of police power to enhance the value of property and improve the health of its citizens did not conflict with the federal power "to regulate commerce in its dormant state"); Gibbons v. Ogden 22 U.S. (9 Wheat) 1 (1824) (states exercising unenumerated powers with "a remote and considerable influence on commerce" do not conflict with and are not derived from unexercised congressional power to regulate interstate commerce).

[55] *See, e.g.*, Pike v. Bruce Church 397 U.S. 137 (1970); Southern Pacific Co. v. Arizona 325 U.S. 761 (1945). As the Court in *Pike* stated, "[w]here the statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits." *Id.* at 142.

[56] *See, e.g.*, Donald Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091 (1986).

[57] 481 U.S. 69 (1987).

proach to the balancing test as it applies to state regulation of corporations.[58]

In *CTS*, the Court addressed the question of whether an Indiana anti-takeover statute that effectively precluded hostile takeovers lacking approval by a majority of a corporation's disinterested shareholders, discriminated against interstate commerce.[59] The Court, reasoning that the statute applied only to domestic corporations formed under the laws of Indiana and applied equally to all hostile tender offers, regardless of whether they originated within or outside the state, held that the law did not discriminate against interstate commerce.[60]

It is possible to analogize the Court's decision in *CTS* to the issue of LLC member liability. In *CTS*, the Court recognized a compelling state interest in the power to regulate corporations formed within the state.[61] It is unclear, however, whether the Court would apply this reasoning in construing the power of a state to regulate the activities of a foreign business entity. One of the issues raised by Dynamics, the tender offeror, was that the Indiana statute would affect interstate commerce by subjecting corporations to inconsistent regulation.[62] In response, the Court stated:

> The Indiana Act poses no such problem. As long as each state regulates voting rights only in the corporations it has created, each corporation will be subject to the law of only one state. No principle of corporation law and practice is more firmly established than a State's authority to define the voting rights of shareholders. See Restatement (Second) of Conflict of Laws Sec. 304 (1971)(concluding that the law of the incorporating State generally should "determine the right of a shareholder to participate in the affairs of the corporation.") Accordingly we conclude that the Indiana Act does not create an impermissible risk of inconsistent regulation by different states.[63]

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[58] As one commentator noted, "After seventeen years of *Pike*, it is unexpected to find an opinion which ignores *Pike*, declaring instead that 'the principal objects of dormant commerce clause scrutiny are statutes that discriminate against interstate commerce,' or burden this commerce by 'subjecting activities to inconsistent regulations.' " Allen Boyer, *When It Comes to Hostile Tender Offers, Just Say No: Commerce Clause and Corporation Law in CTS Corp. v. Dynamics Corp. of America*, 57 U. CIN. L. REV. 539, 584 (1988).

[59] *CTS*, 481 U.S. at 72.

[60] *Id.* at 94.

[61] The Court began its analysis by observing that "state regulation of corporate governance is [a] regulation of entities whose very existence and attributes are a product of state law." *Id.* at 89.

[62] *Id.* at 88-89.

[63] *Id.* at 89.

Applying the Court's reasoning to the issue of LLC member liability, it would seem that *CTS* would allow a state to forbid the creation of LLCs within the state, but would limit the state's power to alter the relationship between a foreign LLC and its members.

Another interpretation of *CTS*, however, seems to undermine this conclusion. In *CTS* the Court stated:

> The principal objects of dormant Commerce Clause scrutiny are statutes that discriminate against interstate commerce. . . . The Indiana act is not such a statute. It has the same effect on tender offers whether or not the offeror is a domiciliary or resident of Indiana. Thus, it "visits equally upon both interstate and local business . . . ."[64]

Applying this line of reasoning to the question of LLC member liability, it seems that a state that chooses not to allow the formation of domestic LLCs as a matter of public policy has, under the Commerce Clause, an absolute right to ignore the limited liability of foreign LLC members, because it is not discriminating against out-of-state interests in favor of in-state interests.

One argument against this line of reasoning is that it logically requires the use of a test to balance the state's regulatory interest with interests of the LLC members, the application of which was widely perceived to have been rejected by the Court in *CTS*.[65] For a state to ignore the limited liability of LLC members would require that the LLC be subjected to inconsistent regulation, which clearly would discriminate against interstate commerce. The only way that this type of regulation could be upheld under the dormant Commerce Clause would be through application of a balancing test as used in *Pike v. Bruce Church* to compare the burden of the regulation with the state's interest in the regulation. *CTS* was the first case in which an anti-takeover statute was not struck down on Commerce Clause grounds, and in applying the *CTS* Court's reasoning, it is significant that the Indiana Act purported to regulate the shareholder's relationship only with corporations formed under the laws of Indiana. In contrast, a state that ignored the limited liability provisions contained in a foreign LLC statute

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[64] *Id.* at 87.

[65] Justice Scalia's concurring opinion specifically rejected the application of the *Pike* balancing test: "[H]aving found . . . that the Indiana [Act] . . . neither 'discriminates against interstate commerce,' . . . nor 'creates an impermissible risk of inconsistent regulation by different States,' . . . I would conclude without further analysis that it is not invalid under the dormant Commerce Clause. *Id.* at 94-95. *See* Boyer, *supra* note 58, at 585 n. 172.

would, in effect, be attempting to regulate the relationship between a business entity formed under the laws of another state and its members.

IV. A CONTRACTUAL JUSTIFICATION FOR LLC MEMBER LIMITED LIABILITY

A contractual view of the firm takes into account the numerous consensual relationships that necessarily result from the firm's business activity.[66] This economic perception of the firm as a nexus of contracts also contemplates that parties will select the business relationship that most reduces their costs of doing business.[67] The role of the law under this world-view is "to enforce private contracts and to provide standard contract terms in the form of common law and statutory rules that the parties can opt out of [sic.]."[68]

Applying these contractual principles to the issue of LLC member liability, it is clear that the parties look to the formation state's LLC statute to define their liability to the LLC and to third parties doing business with the LLC. Because these third parties have the opportunity to negotiate around the limited liability provisions contained in the statute, the absence of any contractual terms providing for the unlimited liability of LLC members in a contract between an LLC and a third party suggests that a meeting of minds has occurred with respect to the limited liability of the LLC's members. Because the function of a court in a contract dispute is to enforce the ex ante expectations of the parties, there is no reason for a court's failure to recognize the limited liability of LLC members.

The recurring theme in the discussion above involves the question of fairness. While both the Due Process and the Full Faith and Credit Clauses are explicit guarantees of fair treatment, the dormant Commerce Clause also limits the individual states's tendency towards opportunistic behavior at the expense of its neighbors's residents and, thus, can also be construed as an assurance of fair treatment. Constitutional concern about fairness to foreign business entities is consistent

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[66] *See* Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937) (arguing that parties form business entities as a means to minimize the contractual transaction costs of business activity).

[67] *See* William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982).

[68] *See* LARRY E. RIBSTEIN, BUSINESS ASSOCIATIONS (2d ed. 1990).

with a contractual view of the nature of the firm, because fairness in this case involves an ex ante examination of the parties' expectations.

While the contractual perspective provides a rationale for recognizing the limited liability of an LLC's members with respect to consensual claimants, it is less persuasive when non-consensual claims are considered. Non-consensual claimants, such as tort victims, do not have an opportunity to bargain with the LLC for value of their claim. Similarly, many of the efficiency considerations that justify limiting an owner's liability to his investment in the firm are not present when the firm is small in size,[69] suggesting that the primary reason small business owners desire limited liability is to externalize risk by placing it on involuntary creditors.[70]

Nonetheless, it does not necessarily follow that LLC members should be stripped of their limited liability simply because the tort claimant did not bargain for the limited liability. While it is true that LLC members have a strong incentive to externalize their risk, they also have an incentive to insure against that risk in order to protect the LLC's assets. The determination to strip the LLC members of their limited liability should be made by reference to the amount of care the LLC members have undertaken to prevent harm to third parties. As one commentator has stated:

> In unlimited liability regimes, firms are led to adopt an optimal level of care, such that the marginal benefit of investment in accident prevention equals the marginal cost of accidents. But limited liability may distort incentives to take preventive measures. When facing limited liability, management might underinvest in accident prevention, because shareholders do not bear any accident costs beyond the amount that triggers bankruptcy . . . Underinvestment in accident prevention increases the profitability of unsafe firms, rendering them more valuable than they would be if they bore the full economic cost of harm prevention.[71]

Thus, if LLC members take a reasonable amount of care in seeking to prevent tortious conduct or in insuring against the damage from such conduct, courts might still enforce the limited liability stipulations contained in the LLC statute.

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[69] *See* Frank Easterbrook & Daniel Fischel, *Limited Liability and the Corporation*, 52 U.CHI. L. REV. 89 (1985).

[70] Ribstein, *supra* note 68, at 61-62.

[71] Francis H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986).

Enforcing limited liability with respect to the claims of non-consensual claimants, where the LLC takes an efficient level of care to provide for those claimants, may even be justified as enforcement of a quasi-contract between the LLC and its non-consensual claimants. Presumably, the non-consensual claimants, ex ante, would have bargained for the firm to take an efficient level of care and realized the benefit of lower prices for the firm's products and services, resulting from the firm having not overinvested in accident protection. Similarly, where the firm failed to take a reasonable amount of care, stripping the owners of their limited liability to pay for the plaintiff's damages might represent payment of expectation damages for breach of the quasi-contract.

CONCLUSION

Limited liability companies should be examined from a contractual perspective, in that the LLC statutes represent, in the absence of negotiation, a set of contractual terms to which the parties who do business with the LLC would have agreed. Because the statutes provide for the limited liability of LLC members, courts should enforce this limited liability as a valid ex ante expectation of the parties to the agreement. The Due Process, Full Faith and Credit, and the dormant Commerce Clauses represent constitutionally mandated fairness principles, ensuring that state courts will not discriminate against foreign business entities in enforcing the contracts between these entities and state residents. As such, these constitutional provisions provide a rationale for recognizing the limited liability of LLC members.

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