

## Why Delaware LLCs?

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*For years, scholars have debated why parties choose to incorporate under Delaware law companies that operate businesses*

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*in other states—since different answers to this question lead to different normative assessments of the practice. Traditionally, this debate focused on public corporations and ignored private firms and noncorporate forms of business. The exploding use of limited liability companies (LLCs) instead of corporations, and the formation of LLCs under Delaware law to operate businesses outside Delaware, call for expanding this discourse to ask “Why Delaware LLCs?” This Article adds to the recent literature seeking to answer this question empirically. It critiques recent studies that looked for statistically significant correlations between state of formation choices for LLCs and differences in state LLC statutes and legal infrastructure. Finding this methodology suffers from inherent limitations, this Article presents results from a different approach. I interviewed business attorneys whose clients have formed LLCs and asked them a battery of questions designed to ascertain why their clients formed LLCs in Delaware. The results of this survey provide important insights into the aspects of Delaware’s substantive LLC law and its legal infrastructure that motivate formation of Delaware LLCs, and thereby serve as an important complement to the existing statistical studies.*

#### INTRODUCTION

A foundation of corporate law in the United States is the ability of parties organizing a corporation to choose the law governing relations among the investors (shareholders) in, and managers (directors and officers) of, the company by the simple act of where the organizers file a piece of paper and without regard to the state in which the company is actually headquartered or does business.<sup>1</sup> This freedom to choose corporate law has been contentious for decades; some characterize it as the “genius of American corporate law,”<sup>2</sup> while others decry it as producing a “race to laxity.”<sup>3</sup>

Traditionally, the debate over free choice of corporate law focused on public corporations, ignoring both nonpublic corporations and noncorporate forms of business.<sup>4</sup> Recent scholarship, however, has moved beyond this confine and begun to examine state of formation

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<sup>1</sup> *E.g.*, FRANKLIN A. GEVURTZ, CORPORATION LAW § 1.2.1 (2010).

<sup>2</sup> *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

<sup>3</sup> *See, e.g.*, Louis K. Liggett Co. v. Lee, 288 U.S. 517, 548–65 (1933) (Brandeis, J., dissenting).

<sup>4</sup> *E.g.*, Larry E. Ribstein & Erin Ann O’Hara, *Corporations and the Market for Law*, 2008 U. ILL. L. REV. 661, 698.

choices by those creating limited liability companies (LLCs). Studies have found that large LLCs, much like public corporations, often form under Delaware law, rather than the law of the state of the company's principal place of business.<sup>5</sup> The proliferation of Delaware LLCs established to operate businesses outside Delaware, in turn, raises questions that go to the core of the normative debate about free choice of law in the corporate—or now the broader business entity—regime. Is Delaware attracting LLC formation by appealing to those expecting to be managers or majority owners of the entity and who prefer laws which are less protective of minority investors (thereby promoting a “race to the bottom”)? Does Delaware's appeal instead lie in reaching a better balancing of interests for all parties (thereby facilitating a “race to the top”)? Does Delaware's legal infrastructure, rather than its substantive rules, explain the decision to form LLCs under Delaware law (implicating neither race to the bottom nor race to the top concerns)? Or is something else going on? Examining these questions in the LLC context is important not only because of the exploding use of LLCs as the vehicle of choice for nonpublic businesses,<sup>6</sup> but also because there is no *a priori* reason to assume the answers and what is at stake will be entirely the same with LLCs as they are for public corporations.

So far, the primary effort to answer these questions empirically occurred in a pair of statistical studies<sup>7</sup> that compared the extent to which parties form LLCs in jurisdictions other than their principal places of business against certain potentially explanatory variables representing differences among the states. Unfortunately, for reasons discussed later,<sup>8</sup> inherent limitations in the methodology employed by these studies renders their results incomplete if not misleading.

Accordingly, this Article presents the results of a study taking a different approach. I sought to gain insight into the motivations for forming LLCs under Delaware law by asking attorneys whose clients formed LLCs in states other than the LLCs' principal places of business, particularly in Delaware, why their clients chose to form the

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<sup>5</sup> See *infra* note 72 and accompanying text.

<sup>6</sup> E.g., Sandra K. Miller, *The Duty of Care in the LLC: Maintaining Accountability While Minimizing Judicial Interference*, 87 NEB. L. REV. 125, 132 (2008) (explaining that more businesses of all types are forming as LLCs than as other noncorporate entities and that LLCs were recently reported as accounting for more new business filings than corporations in twenty-nine states).

<sup>7</sup> See *infra* notes 62, 63 and accompanying text.

<sup>8</sup> See *infra* Part III.B.

LLCs where they did. This entailed either interviewing or obtaining written responses to a survey from over fifty business attorneys working at law firms of various sizes and in different parts of the country. The interview or written survey questions sought information on the reasons behind state of formation choices, including the impact of various statutory provisions, facts about the LLC, and the expected role of the client in the LLC. I further sought to gain information on the sources by which the Delaware judiciary might achieve a reputation relevant to choosing the state of formation for LLCs, and to explore, insofar as possible, the impact of the state of formation choice on the contents of LLC agreements.

While this sort of survey has its own limitations and cannot pretend to offer the statistical significance of studies based upon a data set composed of thousands of LLCs, when combined with—or better yet used to guide—statistical studies, this sort of survey can provide much more robust insights than the statistical studies on their own. Specifically, the results of this survey support the tentative conclusion in one of the statistical studies and contradict the nil finding in the other statistical study as to the importance of the Delaware judiciary in the decision of many of those choosing to organize their LLCs under Delaware law, and also provide more detailed insights into this factor. More significantly, the results of this survey cast doubt on the conclusions of the statistical studies, which found that laws reducing the protections of minority investors had either an inverse or no statistically significant impact on the decision of where to form LLCs. By contrast, in this survey, the attractiveness of such laws commonly loomed large in the minds of attorneys whose clients chose to organize their LLCs under Delaware law. Finally, the survey suggests other factors not investigated in the statistical studies. For example, it points out the role that business attorneys' common familiarity with Delaware's, as well as their home states', LLC law plays in selection of Delaware as a mutually acceptable choice of law for LLCs established by persons from different states. This different sort of legal infrastructure or network advantage possessed by Delaware shows both the utility of uniform business association acts in providing commonly known terms governing firms with owners from different states and also how a single state's law can supply this utility without widespread adoption of a uniform act.

The roadmap for this Article is the following: Part I of this Article situates noncorporate, nonpublic business entities such as LLCs in the debate over the impact of freedom to choose the law governing the

relationship between investors and managers. Part II will examine the existing statistical studies of LLC state of formation. It will explain the limitations of the correlation methods used in these studies. Part III of this Article will describe the methodology and the results of the survey I undertook. Finally, Part IV will outline the implications of the results of the survey and set out an agenda for further studies in this field.

## I

### LLCS AND THE DEBATE OVER CHOICE OF LAW THROUGH STATE OF FORMATION

The ability of parties organizing a corporation to choose the law governing the relationship between investors (shareholders) and managers (directors and officers) rests on two doctrines: the incorporation doctrine, under which parties can organize a corporation under the law of any jurisdiction by filing with and paying a fee to the jurisdiction, when the only other contact of the company in the jurisdiction is a nominal office and agent for service of process,<sup>9</sup> and the internal affairs rule, under which the law of the jurisdiction of incorporation governs the relations among investors and managers.<sup>10</sup>

The debate about the normative impact of these doctrines stems from different assumptions about why persons choose to incorporate outside the state of a company's principal place of business—which commonly means incorporating in Delaware. Those decrying freedom of choice operate on the assumption that persons choosing where to incorporate plan to be managers and often majority owners of the

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<sup>9</sup> See, e.g., MODEL BUS. CORP. ACT § 5.01(10) (2008); DEL. CODE ANN. tit. 8, §§ 101(a), 102(a)(2) (West 2012). By contrast, many continental European nations traditionally operated under the view that corporations must be formed in the nation in which the company had its headquarters—variously called the *siege social*, *siege real*, or seat theory. E.g., Wulf-Henning Roth, *From Centros to Uberseering: Free Movement of Companies, Private International Law, and Company Law*, 52 INT'L & COMP. L.Q. 177, 180–85 (2003). Under this view, a nation would reject the effort to incorporate under its law if the corporate headquarters would be in another nation, and a nation in which a firm had its headquarters would refuse to recognize the firm as a corporation—meaning, for example, the firm would lack the capacity to sue in this nation's courts and its owners might face personal liability—unless the firm incorporated under this nation's, rather than another nation's, laws. E.g., *id.*

<sup>10</sup> See, e.g., RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971); MODEL BUS. CORP. ACT § 15.05 & cmt. (2008). *But see* CAL. CORP. CODE § 2115 (West 2011) (commanding corporations having most of their shareholders, assets, and business in California to follow certain provisions of the California Corporation Code).

company, and that their goal is to find a jurisdiction whose law favors their interests by minimizing the protection of minority investors.<sup>11</sup> Competition among states to draw incorporations (with their fees) in the face of such motivation means adopting laws decreasing minority investor protection, thereby creating a “race for the bottom.”<sup>12</sup> By contrast, those applauding freedom of choice argue that persons choosing the state of incorporation must consider the need to attract investors, and, hence, seek state laws which reflect an optimal balance between competing interests.<sup>13</sup> Competition among states for incorporation under these circumstances produces a “race to the top” for the best corporate laws.<sup>14</sup> Still others have asserted that the motivation for selecting a state of incorporation comes not from the specific content of substantive law, but rather from legal infrastructure—especially the depth of case law and judicial expertise which results from attracting numerous incorporations, and, with more corporations, the opportunity to resolve more corporate law litigation.<sup>15</sup> Lawyers advising clients upon where to incorporate presumably prefer a jurisdiction in which there is more and clearer case law to provide guidance on issues of corporate law and a more sophisticated judiciary to resolve corporate law litigation should it arise.<sup>16</sup> Selection based upon legal infrastructure decreases the pressure that states may have to reduce protection of minority interests in order to attract incorporation, but also may lead parties to incorporate in states with suboptimal statutory terms.<sup>17</sup>

Traditionally, this debate focused on public corporations, as scholars assumed that nonpublic corporations incorporate under the

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<sup>11</sup> E.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1444–45 (1992).

<sup>12</sup> E.g., William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974).

<sup>13</sup> E.g., Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 275 (1977).

<sup>14</sup> E.g., Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 526–27 (2001).

<sup>15</sup> E.g., Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 842–47 (1995).

<sup>16</sup> But see Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 486–87 (1987) (suggesting that attorneys’ selfish financial interest could favor incorporation in a state with more ambiguous corporate law, which would require more billable hours to address).

<sup>17</sup> E.g., Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99, 105 (2004).

law of the state in which they conduct business.<sup>18</sup> A common conflation of nonpublic corporations with small businesses that operate on tight budgets in just one state underlies this assumption.<sup>19</sup> With such “mom and pop” businesses, the common advice is to incorporate in the state in which the company conducts its business—thereby avoiding the added expense of paying fees both to the state of incorporation and to the state in which the company must qualify to do business, as well as avoiding the potential burden of being subject to suit in both the state of incorporation and the state where the company does business.<sup>20</sup> By contrast, public corporations are typically large enough that state franchise fees become a trivial expense relative to the firm’s other expenses and resources.<sup>21</sup> Moreover, public companies commonly conduct business in multiple states—meaning they must pay fees to, and are subject to suit in, multiple states regardless of where the company chooses to incorporate.<sup>22</sup> Also, the difficulties of collective action arguably make shareholders in a public corporation more dependent on state corporate law default rules than the few shareholders in the closely held company, who can meet and draft (and if necessary revise) a contract.<sup>23</sup> Hence, those in charge of public companies, unlike the bulk of nonpublic companies, commonly find it worthwhile to choose their corporate law by incorporating outside the state of the company’s principal place of business—with those following this option predominately choosing Delaware.<sup>24</sup>

The debate about free choice of corporate law has also traditionally ignored unincorporated business firms, such as partnerships and

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<sup>18</sup> E.g., Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684 n.24 (2002).

<sup>19</sup> See, e.g., Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Firms* 4 (The Univ. of Tex. Sch. of Law, Law and Economics Research Paper No. 119, 2007), available at <http://ssrn.com/abstract=1049581> (responding to the literature that assumes nonpublic corporations are small companies that normally incorporate in the state in which they operate by pointing out that nonpublic corporations come in all sizes).

<sup>20</sup> E.g., Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 374–75 (1992).

<sup>21</sup> E.g., Lucian Arye Bebchuk & Alma Cohen, *Firms’ Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 398 (2003).

<sup>22</sup> E.g., Ayres, *supra* note 20, at 374.

<sup>23</sup> See, e.g., Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 10 (2006).

<sup>24</sup> Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775, 1810 (2002) (showing that over half of all public companies incorporate in Delaware).

limited partnerships.<sup>25</sup> This omission has its roots in partnership law. Unlike corporations, which come into existence by virtue of filing with the state<sup>26</sup>—thereby enabling the organizers to choose their governing law by virtue of choosing the state in which to file—formation of partnerships requires no filing.<sup>27</sup> Rather, a partnership automatically results when two or more persons carry on a business as co-owners without establishing any other business form<sup>28</sup>—even in cases in which the persons did not realize they had formed a partnership.<sup>29</sup> This means that partners who wish to select a particular state's partnership law to govern their relationship do so not by filing in a particular state, but by including a choice-of-law clause in their partnership agreement.<sup>30</sup> Conflict of laws rules, however, do not allow the same free choice of partnership law through contractual choice-of-law provisions as established for corporations by the incorporation doctrine and the internal affairs rule.<sup>31</sup> Further rendering the race to the bottom critique less applicable to partnerships, the lack of filing and corresponding fees presumably

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<sup>25</sup> *E.g.*, Ribstein & O'Hara, *supra* note 4, at 698.

<sup>26</sup> *E.g.*, MODEL BUS. CORP. ACT § 2.03 (2008); DEL. CODE ANN. tit. 8, § 101(a) (West 2012).

<sup>27</sup> *E.g.*, FRANKLIN A. GEVURTZ, BUSINESS PLANNING 113 (4th ed. 2008).

<sup>28</sup> *E.g.*, UNIFORM PARTNERSHIP ACT § 2.02(a) (1997).

<sup>29</sup> *See, e.g.*, Holmes v. Lerner, 88 Cal. Rptr. 2d 130 (1999); Minute Maid Corp. v. United Foods, Inc., 291 F.2d 577 (5th Cir. 1961).

<sup>30</sup> *E.g.*, Jennifer J. Johnson, *Risky Business: Choice-of-Law and the Unincorporated Entity*, 1 J. SMALL & EMERGING BUS. L. 249, 275–76 (1997). In the absence of a choice-of-law term in the partnership agreement, the Second Restatement of Conflict of Laws follows the approach applicable to contracts generally, under which the law of the state with the most contacts governs. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 294 (1971). The Revised Uniform Partnership Act simplifies this by calling for the law of the partnership's chief executive office to govern. UNIFORM PARTNERSHIP ACT § 106 (1997).

<sup>31</sup> Under the Restatement approach, choice-of-law provisions govern terms subject to contract, unless doing so would violate a fundamental policy of the state whose law would otherwise apply. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971). The Restatement denies effect to choice-of-law provisions governing terms not subject to contract (such as mandatory fiduciary duties) if the contract chooses the law of a state with no substantial relationship to the parties or the transaction and there is no other reasonable basis for the choice. *Id.* §§ 187, 294. This would seem to put something of a crimp on using choice-of-law terms to avoid mandatory protections for minority partners by shopping the country for a state with lax laws—at least in situations in which the partnership does not have partners in all the states. *But see* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 1.04 (Supp. 2002-2) (choice-of-law clauses are now enforced so commonly in general partnerships that the result approximates the internal affairs rule).

reduces the incentives for states to create rules favorable to those deciding which state's law should govern their partnership.<sup>32</sup>

Formation by filing appears on the scene with limited partnerships<sup>33</sup> and, as a result, parties organizing limited partnerships have the freedom to choose the law governing their relations simply by virtue of where they file.<sup>34</sup> Many of the organizers of publicly held limited partnerships (so-called master limited partnerships) have taken advantage of this to organize their limited partnerships under Delaware law<sup>35</sup>—a phenomenon that a practitioner writing in the area<sup>36</sup> seems to attribute to a provision in Delaware's limited partnership act calling for maximum freedom of contract and allowing the limited partnership agreement to waive all fiduciary and other duties except that of good faith.<sup>37</sup> Even so, scholars by and large have ignored the implications of free choice of limited partnership law—whether this produces a race to the bottom, optimum law, or selection based upon legal infrastructure. In part, this may reflect an assumption that the near-universal adoption by the states of a uniform law governing limited partnerships<sup>38</sup>—something which has been also true in the partnership context<sup>39</sup>—reduces the incentives for parties to consider choice of law by formation in a state other than that of the

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<sup>32</sup> See, e.g., Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 548–49 (1990) (stating that franchise fees motivated New Jersey and Delaware efforts to obtain corporate charters).

<sup>33</sup> E.g., UNIFORM LIMITED PARTNERSHIP ACT § 201 (2001).

<sup>34</sup> *Id.* § 114 (providing that to form under a state's law, a limited partnership need only have an office, which need not be its business office, in the state for service of process); *id.* § 901 (codifying the internal affairs rule for limited partnerships).

<sup>35</sup> E.g., Ribstein & O'Hara, *supra* note 4, at 705.

<sup>36</sup> John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471, 485–86 (2005).

<sup>37</sup> Delaware Revised Uniform Limited Partnership Act, DEL. CODE ANN. tit. 6, § 17-1101 (West 2012).

<sup>38</sup> Every state other than Louisiana has enacted some form of the Uniform Limited Partnership Act (ULPA). See The Nat'l Conference of Comm'rs on Unif. State Laws, *Legislative Fact Sheet – Limited Partnership Act*, UNIFORM L. COMMISSION, <http://uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Partnership%20Act> (last visited Feb. 7, 2012) (listing eighteen states as having enacted the ULPA (2001)); Revised Uniform Limited Partnership Act (1976), 6B U.L.A. 1–2 (2008) (listing forty states as having enacted the RULPA (1976), only nine of which are among the eighteen states that subsequently enacted the ULPA (2001)).

<sup>39</sup> E.g., The Nat'l Conference of Comm'rs on Unif. State Laws, *Acts: Partnership Act*, UNIFORM L. COMMISSION, <http://www.uniformlaws.org/Act.aspx?title=Partnership%20Act> (last visited July 4, 2012) (all states but Louisiana adopted the Uniform Partnership Act of 1914 and thirty-seven states subsequently adopted the Revised Uniform Partnership Act of 1997).

firm's principal place of business.<sup>40</sup> In part, it may reflect an assessment of the somewhat narrow and declining significance of limited partnerships as a form of business.<sup>41</sup>

In the last couple of decades, another unincorporated business form has become ubiquitous in the United States. This is the limited liability company (LLC), which Germany invented in the late 1800s,<sup>42</sup> spread throughout Civil Law nations thereafter,<sup>43</sup> and Wyoming imported into the United States in 1977.<sup>44</sup> While the original purpose of the LLC outside the United States was to allow owners of non-publicly held businesses to obtain limited liability without meeting the strictures imposed for the protection of public investors on companies able to issue marketable stock,<sup>45</sup> in the United States the objective is to have a form of business allowing limited liability for all owners (rather than just limited partners) that nevertheless qualifies for treatment as a partnership under federal income tax law.<sup>46</sup> After a favorable ruling by the Internal Revenue Service in 1988 on the tax status of LLCs,<sup>47</sup> LLC statutes quickly spread from state to state.<sup>48</sup> The pace of the spread outstripped efforts to create a uniform act governing the new entity—and when the uniform act did appear, only a few states adopted it.<sup>49</sup> As a result,

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<sup>40</sup> *E.g.*, GEVURTZ, *supra* note 27, at 116.

<sup>41</sup> *See* JEFFREY W. BULLOCK, SEC'Y OF STATE, DELAWARE DIVISION OF CORPORATIONS: 2010 ANNUAL REPORT 1 (2011), available at <http://corp.delaware.gov/10CorpAR.pdf> (showing that in Delaware from 2008 through 2010, 234,224 LLCs and 82,637 corporations, but only 19,473 limited partnerships and LLPs combined, were formed).

<sup>42</sup> *E.g.*, Marcus Lutter, *Limited Liability Companies and Private Companies*, in INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW, pt. 1, ch. 2, at ch. 2-6 (Alfred Conard & Detlev Vagts eds., 1998).

<sup>43</sup> *Id.* at ch. 2-11.

<sup>44</sup> *E.g.*, Lieberman v. Wyoming.com LLC, 11 P.3d 353, 356–57 (2000) (citations omitted).

<sup>45</sup> *E.g.*, Lutter, *supra* note 42, at ch. 2-6.

<sup>46</sup> *E.g.*, Jonathan R. Macey, *The Limited Liability Company: Lessons for Corporate Law*, 73 WASH. U. L.Q. 433, 434 (1995).

<sup>47</sup> Rev. Rul. 88-76, 1988-2 C.B. 360.

<sup>48</sup> *E.g.*, Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 405–06 (1995).

<sup>49</sup> Only thirteen states have adopted either the Uniform Limited Liability Company Act (ULLCA) or the Revised Uniform Limited Liability Company Act (RULLCA). *See* The Nat'l Conference of Comm'rs on Unif. State Laws, *Legislative Fact Sheet – Limited Liability Company (Revised)*, UNIFORM L. COMMISSION, [http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20\(Revised\)](http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20(Revised)) (last visited Feb. 5, 2012) (listing five states, Idaho, Iowa, Nebraska, Utah, and Wyoming, which have adopted the RULLCA); Unif. Ltd. Liab. Co. Act (1996), 6B U.L.A. 545

LLC acts have a degree of variation that might encourage parties to consider choice of law concerns when deciding in which state to file the papers required by the LLC statutes to organize the company.<sup>50</sup> Provisions in LLC statutes importing both the incorporation doctrine<sup>51</sup> and the internal affairs rule<sup>52</sup> facilitate this choice.

In fact, a substantial number of LLCs have organized under Delaware law, despite having their principal places of business in other states. These are typically larger businesses<sup>53</sup>—showing the error in the assumption that nonpublic firms (which, for tax reasons, LLCs generally are<sup>54</sup>) operate only “mom and pop” businesses. Yet, one cannot assume that the reasons for this phenomenon and its normative implications are necessarily the same as is the case for public corporations. For example, it is not self-evident that the extensive case law and expert judiciary Delaware established through its history of litigation involving the internal affairs of public corporations automatically translates into a superior legal infrastructure to deal with the problems of nonpublic, noncorporate business entities that can tailor their governance rules by detailed contract.<sup>55</sup> Moreover, the debate involving the race to the bottom

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(2008) (listing eight states, Alabama, Hawaii, Illinois, Montana, South Carolina, South Dakota, Vermont, and West Virginia, which have adopted the ULLCA).

<sup>50</sup> *E.g.*, Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6, § 18-201 (West 2012); CAL. CORP. CODE § 17050 (West 2011).

<sup>51</sup> *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-104(a)(1) (requiring Delaware LLCs to have a registered office in Delaware, which may, but need not, be its place of business).

<sup>52</sup> *E.g.*, CAL. CORP. CODE § 17450 (providing that the law of state of formation governs internal affairs of a foreign LLC); DEL. CODE ANN. tit. 6, § 18-901 (same); Bruce H. Kobayashi & Larry E. Ribstein, *The Non-Uniformity of Uniform Laws*, 35 J. CORP. L. 327, 331 (2009) (all states generally follow internal affairs rule for foreign LLCs). *But see* CAL. CORP. CODE § 17453 (granting members of a foreign LLC, who reside in California and who own at least twenty-five percent of the voting interest in the LLC, inspection rights under California LLC law).

<sup>53</sup> *See infra* note 72 and accompanying text.

<sup>54</sup> Partnership-style tax treatment (the goal for using an LLC instead of a corporation) is not available for publicly traded firms except in certain industries. I.R.C. § 7704 (2009).

<sup>55</sup> Demonstrating what many might argue is a lack of sophistication in dealing with nonpublic companies, Delaware courts have been insensitive to the unique problems facing minority shareholders in closely held corporations. In *Nixon v. Blackwell*, 626 A.2d 1366, 1379–81 (Del. 1993), the Delaware Supreme Court expressly rejected the pioneering Massachusetts’ approach that had recognized special fiduciary duties between shareholders in closely held corporations, *e.g.*, *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975) (requiring majority shareholders in close corporations to give minority shareholders an equal opportunity to sell their stock back to the corporation when the corporation repurchases stock from the majority); *see also* *Riblet Prods. Corp. v. Nagy*, 683 A.2d 37 (Del. 1996) (rejecting the approach in *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976), in which the Massachusetts

versus to the top with respect to the protection of minority investors may be different in the LLC context. For one thing, a lengthy contract commonly dictates owners' rights in an LLC,<sup>56</sup> which many might argue lessens the need for state law minority investor protections.<sup>57</sup> Cutting the other way, the argument made by some scholars—that the threat of increased federal intervention through securities law operates as a major constraint on how much Delaware is willing to favor manager or majority owner interests<sup>58</sup>—applies less with LLCs. This is because the interests in LLCs often may not constitute securities<sup>59</sup> and, in any event, LLCs rarely sell interests in the company in public offerings or list such interests for trading on a national securities exchange.<sup>60</sup> Thus LLCs are rarely subject to most federal securities regulation.<sup>61</sup>

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Supreme Court required majority shareholders in close corporations to show a legitimate corporate purpose for actions which harm the minority. When coupled with the lack of any statutory remedy for oppression available to minority shareholders in Delaware, the result is to place minority shareholders in closely held Delaware corporations at the mercy of the majority in a manner long criticized by leading scholars concerned with closely held corporations. *See, e.g.*, 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS § 10:3 (2012), available at Westlaw. Moreover, a well-developed body of court opinions and judicial expertise would seem to be of greatest utility when dealing with legal doctrines that are mandatory and imprecise, such as some fiduciary duties and various other rules in the corporate context. Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 221–24 (2011). The ability of members in an LLC to tailor their relationship through a detailed contract, however, may allow participants in an LLC to supplant such doctrines with governing rules that require less judicial intervention. *Id.* at 225–27. The result may be to reduce the advantage Delaware obtains from its judicial expertise and experience in the public corporate context. *Id.* at 234–35.

<sup>56</sup> *E.g.*, *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999); *see* GEVURTZ, *supra* note 27, at 118.

<sup>57</sup> *E.g.*, *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, No. 3803-CC, 2008 WL 3846318, at \*8 (Del. Ch. Aug. 19, 2008), available at <http://www.courts.state.de.us/opinions/download.aspx?ID=110340>; Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 32 J. CORP. L. 565, 585 (2007).

<sup>58</sup> *See, e.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 616–17 (2003).

<sup>59</sup> *See, e.g.*, *Robinson v. Glynn*, 349 F.3d 166, 170, 174 (4th Cir. 2003).

<sup>60</sup> *E.g.*, Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 480 (2009).

<sup>61</sup> *See, e.g.*, Securities Act of 1933, § 4(a)(2), 15 U.S.C. § 77d(a)(2) (2012) (exempting sales which are not a public offering from the Act's registration requirements); Securities Exchange Act of 1934, §§ 12–14, 15 U.S.C. 78l, 78m, 78n (2012) (excluding companies which have neither securities listed for trading on a national exchange nor at least 500 securities holders from registration requirements, most federal regulation regarding tender offers, and federal proxy rules).

Assessing the normative implications of allowing unfettered freedom to choose the governing LLC law requires asking why organizers form LLCs under Delaware law in order to operate businesses in other states. One can try to answer this question by poring through statistics on state of formation choices for LLCs looking for statistically significant correlations with differences in law and legal infrastructure between the states, or one can take the direct approach of asking those involved in such decisions. The two existing studies have taken the former approach, while I have taken the latter. Together, these two methodologies combine to create a more robust picture than possible by either methodology on its own.

## II THE EXISTING STUDIES

### A. *The Dammann & Schündeln and Kobayashi & Ribstein Studies*

Two sets of researchers, Jens Dammann and Matthias Schündeln,<sup>62</sup> and Bruce Kobayashi and Larry Ribstein,<sup>63</sup> have attempted to ascertain the motivations for forming LLCs in states other than the states of the companies' principal places of business. Following a methodology common to much empirical research, these studies investigated motivations by testing for statistically significant correlations between LLC state of formation data and potentially motivating differences among the states.

It all begins with a data set. For these two studies, the primary data set comes from the Bureau van Dijk's ICARUS database,<sup>64</sup> which contains information on U.S. and Canadian companies of all sizes.<sup>65</sup> Critically, this database shows both the location of the companies' principal places of business and the companies' states of "incorporation" (or, more accurately in the context of noncorporate

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<sup>62</sup> Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, Law and Economics Research Paper No. 126, University of Texas School of Law: 5th Annual Conference on Empirical Legal Studies (June 28, 2010), available at <http://ssrn.com/abstract=1633472>.

<sup>63</sup> Bruce H. Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91 (2011).

<sup>64</sup> *Id.* at 113; Dammann & Schündeln, *supra* note 62, at 4.

<sup>65</sup> *Icarus: Company Information and Business Intelligence for the U.S. and Canada*, BUREAU VAN DIJK, <http://www.bvdinfo.com/Products/Company-Information/National/ICARUS.aspx> (last visited July 15, 2012).

entities such as LLCs, the states of legal formation).<sup>66</sup> This information allowed first Dammann and Schündeln (D&S), and subsequently Kobayashi and Ribstein (K&R), to determine the proportion of LLCs with a principal place of business in each state that formed under the law of another state (outbound migration).<sup>67</sup> It also allowed the two teams to determine the proportion of LLCs with a principal place of business in other states that formed under the law of each state (inbound migration).<sup>68</sup>

D&S initially used this data to confirm a couple of propositions that they and others probably already suspected—if for no other reason than because of reported court opinions involving Delaware LLCs operating businesses outside of Delaware.<sup>69</sup> The ICARUS database contained information on the number of employees working for each company, which D&S could use as a measure for the size of the business operated by the LLC.<sup>70</sup> Comparing size (measured by number of employees) versus state of formation, D&S established that, while smaller LLCs normally followed the conventional advice for small business and formed under the law of the state in which they had their principal place of business, larger LLCs often departed from this practice and organized under the law of a state different than their principal place of business.<sup>71</sup> D&S also found that Delaware was the biggest winner when larger LLCs chose to form in a state other than that of the LLC’s principal place of business.<sup>72</sup>

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<sup>66</sup> While the database does not directly report the form of business used by companies, the researchers could separate out the LLCs by the commonly required suffix “LLC” or “Limited Liability Company,” *see, e.g.*, DEL. CODE ANN. tit. 6, § 18-102(1) (West 2012), found in the names of the LLCs. Dammann & Schündeln, *supra* note 62, at 4–5; Kobayashi & Ribstein, *supra* note 63, at 113.

<sup>67</sup> Dammann & Schündeln, *supra* note 62, at 6; Kobayashi & Ribstein, *supra* note 63, at 113–17.

<sup>68</sup> Dammann & Schündeln, *supra* note 62, at 6; Kobayashi & Ribstein, *supra* note 63, at 113–17.

<sup>69</sup> *See, e.g.*, Weber v. U.S. Sterling Sec., Inc., 924 A.2d 816 (Conn. 2007) (discussing a Delaware LLC that was conducting business in New York); Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286 (Del. 1999) (discussing a Delaware LLC formed by a California and New York corporation); Zrii, LLC v. Wellness Acquisition Grp., Inc., No. 4374-VCP, 2009 WL 2998169 (Del. Ch. Sept. 21, 2009) (discussing a Delaware LLC that had its principle place of business in Utah); Metro Commc’n Corp. BVI v. Advanced Mobilecomm Techs. Inc., 854 A.2d 121 (Del. Ch. 2004) (discussing a Delaware LLC that was conducting business in Latin and South America).

<sup>70</sup> Dammann & Schündeln, *supra* note 62, at 6.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* Kobayashi and Ribstein confirmed this result but also found some inbound migration to Florida and Nevada. Kobayashi & Ribstein, *supra* note 63, at 116.

The more difficult question is why larger LLCs form in states, especially Delaware, other than the state of their principal place of business. To answer this question, both the D&S research team and the K&R research team compared various differences among the states against the degree to which LLCs with a principal place of business in each state would organize under the laws of another state.<sup>73</sup> Of course, it is impractical to compare LLC state of formation statistics against every other conceivable difference between the states to see if there is a statistically significant correlation. Hence, the researchers sought differences that would allow them to test various hypotheses derived from academic legal literature and the researchers' analysis as to why persons organizing LLCs might choose formation under the law of a different state than the state of the LLC's principal place of business.<sup>74</sup>

D&S looked for potentially explanatory variables in substantive law and in legal infrastructure.<sup>75</sup> In the area of substantive law, D&S wanted to test the hypotheses that those controlling the decision of where to form LLCs would, because they expect to be owners, favor the interests of owners over creditors of the company, and would, because they expect to be managers or majority owners, favor managers and majority owners over minority investors in the company—in other words, the propositions at the heart of the race to the bottom debate.<sup>76</sup> Hence, D&S tested, as potentially explanatory variables, provisions in LLC statutes that D&S believed either protected owners from creditors or decreased the protection of minority investors from actions by managers and majority owners. In terms of legal infrastructure, D&S worked from the hypotheses that the quality of the state's judiciary, as well as network effects from commonly adopted or long-existing LLC laws (meaning, for example, more judicial interpretation of statutory language), could motivate selection of a state as the state of LLC formation.<sup>77</sup> Hence, D&S tested as potentially explanatory variables a ranking they believed measured judicial quality, as well as whether the state adopted the

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<sup>73</sup> Dammann & Schündeln, *supra* note 62, at 6–7; Kobayashi & Ribstein, *supra* note 63, at 112, 129–36.

<sup>74</sup> Dammann & Schündeln, *supra* note 62, at 6–7; Kobayashi & Ribstein, *supra* note 63, at 112, 129–36.

<sup>75</sup> Dammann & Schündeln, *supra* note 62, at 6–15.

<sup>76</sup> *Id.* at 6–7.

<sup>77</sup> *Id.* at 13–15.

Uniform Limited Liability Company Act and when the state first enacted an LLC law.<sup>78</sup>

In the first iteration of their study released in 2008,<sup>79</sup> D&S grabbed attention by claiming a statistically significant inverse relationship between less minority investor protection, as well as less prospect of managerial liability, and state of formation choices for LLCs<sup>80</sup>—in other words, parties choosing where to form LLCs seemed to prefer laws protecting minority investors and increasing the likelihood of liability of managers. As the authors characterized it, there was a “flight from laxity,” rather than a race to the bottom.<sup>81</sup> In a 2010 revision of their paper, D&S largely continue to stand by this result, but changed, without explanation, a number of their other results in areas such as creditor protection and legal infrastructure.<sup>82</sup> Neither iteration of the study found—contrary to expectations from the legal literature—a statistically significant correlation between judicial quality and state of formation choices.<sup>83</sup>

Disagreeing with most of the variables D&S chose to test, K&R came up with a new list. Like D&S, K&R assumed that judicial quality, as well as network effects from having an LLC statute with provisions common among states, may motivate choice of state of formation by those organizing LLCs.<sup>84</sup> However, K&R came up with different variables to measure judicial quality and such statutory network effects than the variables used by D&S.<sup>85</sup> With respect to provisions of substantive law decreasing protection of creditors and minority investors (the race to the bottom thesis), K&R came up with

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<sup>78</sup> *Id.* at 6–14.

<sup>79</sup> Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, Law and Economics Research Paper No. 126, University of Texas School of Law: 3rd Annual Conference on Empirical Legal Studies (Apr. 28, 2008), available at <http://ssrn.com/abstract=1126257>.

<sup>80</sup> *Id.* at 27–28.

<sup>81</sup> *Id.* at 19.

<sup>82</sup> Dammann & Schündeln, *supra* note 62, at 15–19. The 2010 paper claims a statistically significant correlation between state of formation choices and decreased likelihood of liability to creditors and a statistically significant inverse correlation between selection of a state in which to form LLCs and adoption of the Uniform LLC Act, *id.*, whereas, in both cases, the 2008 paper reported no statistically significant correlations, Dammann & Schündeln, *supra* note 79, at 21–22. The 2010 paper introduces a variable looking at freedom of contract, Dammann & Schündeln, *supra* note 62, at 14, but does not discuss results for this variable.

<sup>83</sup> Dammann & Schündeln, *supra* note 62, at 19; Dammann & Schündeln, *supra* note 79, at 21–22.

<sup>84</sup> Kobayashi & Ribstein, *supra* note 63, at 103–09.

<sup>85</sup> *Id.*

another set of variables different than those used by D&S. In the case of minority investor protection and managerial liability, K&R also shifted focus and terminology, testing the hypothesis that organizers look for laws allowing themselves “flexibility,” which, among other things, can entail contracting out of minority investor protections.<sup>86</sup> Finally, K&R added a variable they believed measured innovation as an additional substantive law factor not tested by D&S.<sup>87</sup>

K&R failed to produce any attention-grabbing result; indeed, they asserted that their results undercut D&S’s surprising race from laxity conclusion.<sup>88</sup> This was not because K&R found a race toward laxity. Rather, they found no statistically significant correlation between LLC state of formation choices and statutory provisions either dealing with creditor rights or allowing flexibility.<sup>89</sup> As a matter of fact, K&R, for the most part, found no statistically significant correlation between LLC state of formation choices and the substantive terms of LLC statutes.<sup>90</sup> Indeed, almost the only significant correlation to any motivational factor found by K&R was—contradicting D&S—judicial quality.<sup>91</sup> From these results, K&R drew the conclusion that efforts expended by state legislatures to draft and change their LLC statutes were not worthwhile, at least if the goal is attracting the formation of LLCs to the state.<sup>92</sup>

### *B. Limitations of the Correlation Methodology*

As interesting and potentially useful as the results of the D&S and K&R studies are, the stories they tell about the motivations for forming LLCs under Delaware law, or under the law of other states beyond the LLCs’ principal places of business, are incomplete and potentially misleading. This is because of two problems inherent in the correlation methodology.

The first problem—commonly known if often ignored—lies in the old saw that “correlation does not prove causation.” The legal infrastructure or judicial quality hypothesis provides a simple illustration in its original corporate context. This hypothesis posits that an extensive body of case law and an experienced judiciary

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<sup>86</sup> *Id.* at 104–05.

<sup>87</sup> *Id.* at 105–06.

<sup>88</sup> *Id.* at 109–12, 133–34.

<sup>89</sup> *Id.* at 132, 135.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.* at 136.

<sup>92</sup> *Id.* at 128–32, 136.

dealing with corporate law issues will attract incorporation in the state.<sup>93</sup> The manner in which the state obtains such an extensive body of case law and experienced judiciary, however, is to have already attracted a large number of corporations to form in the state.<sup>94</sup> This means that a correlation study will show a statistically significant correlation between a state having the desirable judicial infrastructure and the extent of incorporation in the state, but this will not prove that the desirable judicial infrastructure caused, as opposed to simply resulted from, the large number of companies incorporating in the state.<sup>95</sup>

The other problem with the correlation studies involves choosing the explanatory variables to compare with the LLC state of formation statistics. D&S and K&R had to determine the hypotheses regarding the motives for LLC state of formation choices that they would test and the specific factual variables they would use to test each hypothesis. K&R's criticisms of D&S illustrate that both of these determinations stem from judgments upon which researchers can easily disagree. All the statistical wizardry in the world cannot create more complete and useful results than are possible given the particular selection of comparisons for testing.

Consider first the hypotheses tested in the two studies. The hypotheses tested by D&S, as well as by K&R, largely involved the state's judiciary and the LLC statute. This means the studies will miss the relevant motive for LLCs in which the choice to organize under the law of a state other than the LLC's principal place of business stems from reasons different than the state's judiciary or LLC statute.

To illustrate this point, suppose that organizers of a substantial number of LLCs form under Delaware law because the organizers' attorneys know Delaware law. Alternately, suppose that organizers of a substantial number of LLCs choose to form under Delaware law because they desire the perceived prestige or "brand" value associated with being a Delaware business entity—perhaps because large public

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<sup>93</sup> See *supra* note 16 and accompanying text.

<sup>94</sup> *Id.*

<sup>95</sup> One might argue that the correlation of LLC state of formation statistics with judicial infrastructure more likely suggests causation because the legal infrastructure resulted from corporations rather than LLCs. Yet, this begs the question of why a judicial infrastructure equipped for public corporations would necessarily be attractive to those forming LLCs, thereby raising the question of whether the correlation results from some other factor.

corporations often incorporate in Delaware.<sup>96</sup> Since correlation studies cannot tell us anything about hypotheses they do not test, and since the D&S and K&R studies did not test these hypotheses, they will miss why these LLCs formed under Delaware law. The moral is that correlation studies like those undertaken by D&S and K&R stand a good chance of missing potentially important motivational factors unless the researchers have some method for assuring that the hypotheses they test have covered every realistic possibility.

The dispute between D&S and K&R was, for the most part, not about the hypotheses to test; rather, it was about what specific factual variables the study should use to test each hypothesis.<sup>97</sup> This dispute arises because there are no simple factual metrics labeled “judicial quality relevant to LLCs” or “laxity in protecting creditors or minority investors in the context of LLCs.” Instead, D&S and K&R had to come up with specific factual variables that would serve as proxies for the broader motivational factor under each hypothesis.<sup>98</sup> To the extent these proxies do not truly reflect the underlying hypothesis, the correlation, or lack thereof, tells us very little.

For their measure of judicial quality, D&S used a ranking of state courts prepared by the U.S. Chamber of Commerce.<sup>99</sup> As K&R point out, however, critics have asserted that the Chamber of Commerce ranking stems largely from the proclivity of courts in the state to award punitive damages.<sup>100</sup> Unless punitive damage awards are an important feature of litigation involving the internal affairs of LLCs—as opposed to certain personal injury or consumer protection litigation—this criteria is fairly irrelevant to those aspects of judicial

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<sup>96</sup> In fact, as discussed below, these motivations did turn up in a fair number of responses to the survey I conducted. *See infra* text between notes 237 and 238, and 240 and 241.

<sup>97</sup> Kobayashi and Ribstein also criticized the statistical methodology used by Dammann and Schündeln, especially Dammann and Schündeln’s failure to compare inbound and outbound migration for individual LLCs by each variable in order to see whether the LLCs were moving to states that actually differed on the particular variable. Kobayashi & Ribstein, *supra* note 63, at 133–35.

<sup>98</sup> *Id.* at 104; Dammann & Schündeln, *supra* note 62, at 5.

<sup>99</sup> Dammann & Schündeln, *supra* note 62, at 5 (relying on U.S. CHAMBER INST. FOR LEGAL REFORM, 2007 U.S. CHAMBER OF COMMERCE STATE LIABILITY SYSTEMS RANKING STUDY (2007), available at [http://www.instituteforlegalreform.com/sites/default/files/images2/stories/documents/pdf/research/2007liability\\_system\\_ranking\\_study.pdf](http://www.instituteforlegalreform.com/sites/default/files/images2/stories/documents/pdf/research/2007liability_system_ranking_study.pdf)).

<sup>100</sup> Kobayashi & Ribstein, *supra* note 63, at 129 (citing, as an example, Theodore Eisenberg, *U.S. Chamber of Commerce Liability Survey: Inaccurate, Unfair, and Bad for Business*, 6 J. EMPIRICAL LEGAL STUD. 969, 978–87 (2009)).

quality potentially important in selecting the state of formation for LLCs.<sup>101</sup> To deal with the questionable relevance of the Chamber of Commerce ranking, K&R also tested rankings based upon how often state courts had their opinions cited and how many opinions each judge wrote,<sup>102</sup> as well as the number of opinions of each state's courts that dealt with LLC issues.<sup>103</sup> Recognizing, however, that the citation and productivity rankings were not limited to LLC cases, and that the quantity of opinions about LLCs may say nothing about the quality of the opinions, K&R were understandably tentative in the conclusions they drew from the correlations their study found regarding judicial quality.<sup>104</sup>

Another aspect of infrastructure tested by both teams involved the typicality of the state's LLC statute—the hypothesis being that a statute which is more typical among states may have more interpretative opinions, or may otherwise establish a greater comfort level for attorneys recommending in which state their clients should form LLCs.<sup>105</sup> As a variable to measure this hypothesis, D&S used adoption by the state of the Uniform Limited Liability Company Act.<sup>106</sup> Treating adoption of a uniform act as the proxy for having a typical statute could make sense (even if it would only give results for a few outlier states) if, as historically been the case with the Uniform

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<sup>101</sup> While formation of an LLC under the law of a state opens the LLC to suit in that state, this does not mean the LLC cannot be sued in another state in which a dispute arose, it entered a contract, or an accident occurred. *See* STEPHEN N. SUBRIN ET AL., *CIVIL PROCEDURE: DOCTRINE, PRACTICE, AND CONTEXT* 634–36 (3d ed. 2008). If such other state has a greater proclivity to award punitive damages, one can expect third party plaintiffs to choose this option over bringing the suit in the state of formation. Also, of course, the issue of whether to award punitive damages in a suit by a third party against an LLC does not fall within the internal affairs rule. *See, e.g.,* *McDermott Inc. v. Lewis*, 531 A.2d 206, 214–15 (Del. 1987) (explaining the scope of the internal affairs rule). Actually, one suspects that the Chamber of Commerce may have viewed a reduced proclivity to award punitive damages (typically against businesses) as not only important on its own, but also as reflective of a broader “pro-business” (or really pro-defendant) attitude in the state's judicial system. If so, then use of this variable may be testing less the legal infrastructure hypothesis than it is the reduced minority investor protection hypothesis. *See* Cary, *supra* note 12, at 669–72 (pointing to pro-defendant attitude of Delaware courts in corporate law cases as part of the way in which Delaware seeks to appeal to those planning to be directors or majority shareholders).

<sup>102</sup> Kobayashi & Ribstein, *supra* note 63, at 129 (including as a proxy, Stephen J. Choi et al., *Which States Have the Best (and Worst) High Courts?* (Chi. John M. Olin Law & Econ., Working Paper No. 405, 2008), available at <http://ssrn.com/abstract=1130358>).

<sup>103</sup> *Id.* at 129–30.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 107–08; Dammann & Schündeln, *supra* note 62, at 13–14.

<sup>106</sup> Dammann & Schündeln, *supra* note 62, at 13–14.

Partnership and Uniform Limited Partnership Acts,<sup>107</sup> almost every state adopted the Uniform Limited Liability Company Act. Here, however, not only have relatively few states adopted the Uniform Limited Liability Company Act,<sup>108</sup> but many provisions in the Uniform Limited Liability Company Act are quite different from the LLC statutes in most states.<sup>109</sup> Hence, K&R created a variable based upon the degree to which the state's LLC act contained provisions common to other states' LLC acts.<sup>110</sup> Yet, such a variable may say little without some qualitative assessment as to the significance of the provisions that are, and are not, common.<sup>111</sup> Finally, since a similar effect of more case law and greater familiarity can also arise from the statute's longevity, both K&R and D&S used the vintage of the states' LLC laws as another variable.<sup>112</sup> Given the speed with which LLC statutes spread from state to state in the early 1990s,<sup>113</sup> and passage of time since then, it is difficult to see how much significance this is likely to have.

In their effort to measure each state's protection of LLC creditors, D&S decided to focus on how the states apply the doctrine of piercing the corporate veil to LLCs.<sup>114</sup> This frequently litigated doctrine<sup>115</sup> allows a court, in the case of certain inequitable conduct, to take away the limited liability normally enjoyed by the controlling owner of a corporation<sup>116</sup> or LLC,<sup>117</sup> and so would seem a potentially important

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<sup>107</sup> See *supra* notes 38 and 39 and accompanying text.

<sup>108</sup> See *supra* note 49 and accompanying text.

<sup>109</sup> E.g., Bruce H. Kobayashi & Larry E. Ribstein, *The Non-Uniformity of Uniform Laws*, 35 J. CORP. L. 327, 342, 350 (2009).

<sup>110</sup> Kobayashi & Ribstein, *supra* note 63, at 107.

<sup>111</sup> Kobayashi and Ribstein recognize this point when they attempt to separately analyze provisions dealing with tax and third-party rights, where they view uniformity as important, and rights between the members, where they argue that uniformity is less important. *Id.* Still, not every provision involving rights between the members of an LLC is of the same salience; a provision allowing waiver of all duties between members would presumably be more important than a provision specifying default rules for meetings between members.

<sup>112</sup> *Id.* at 132; Dammann & Schündeln, *supra* note 62, at 14–15.

<sup>113</sup> See *supra* note 48.

<sup>114</sup> Dammann & Schündeln, *supra* note 62, at 7–8.

<sup>115</sup> E.g., Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1036 & n.1 (1991) (stating that piercing constitutes the most frequently litigated corporate law topic (if one treats various fiduciary duty claims as separate topics)).

<sup>116</sup> E.g., *Sea-Land Servs., Inc. v. Pepper Source*, 993 F.2d 1309 (7th Cir. 1993); *Kinney Shoe Corp. v. Polan*, 939 F.2d 209 (4th Cir. 1991); *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976).

metric of a state's protection of creditors. Yet D&S used a questionable variable to measure a state's proclivity toward piercing an LLC. Specifically, as their measure of differences between states in the area of piercing, D&S used the presence or absence of a provision in the state's LLC statute that bars piercing LLCs based upon the owners' failure to follow formalities regarding meetings.<sup>118</sup> D&S operated on the assumption that such a provision decreases the danger that courts will pierce an LLC. This, however, gives such statutory provisions far more credit than they deserve. To begin, since LLC statutes do not call for the observance of so-called corporate formalities involving meetings—such as mandatory annual shareholder meetings to elect directors<sup>119</sup>—courts can figure out that the failure to observe such meeting formalities should not be a factor leading to piercing LLCs even without the LLC statute pointing out the obvious.<sup>120</sup> Besides, despite their common mention in corporate piercing cases<sup>121</sup> and in literature dealing with the doctrine,<sup>122</sup> the failure to follow such corporate formalities does not really lead to piercing the veil even in the corporate context.<sup>123</sup> Making D&S's use of this variable even more questionable, the drafters of these

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<sup>117</sup> *E.g.*, *In re Suhadolnik*, No. 08-71951, 2009 WL 2591338 (Bankr. C.D. Ill. Aug. 20, 2009); *Ledy v. Wilson*, 831 N.Y.S.2d 61 (N.Y. App. Div. 2007); *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573 (Tex. App. 2007).

<sup>118</sup> *Dammann & Schündeln*, *supra* note 62, at 8.

<sup>119</sup> *See, e.g.*, MODEL BUS. CORP. ACT § 7.01(a) (2008).

<sup>120</sup> *E.g.*, *NetJets Aviation, Inc. v. LHC Commc'ns, LLC*, 537 F.3d 168, 178 (2d Cir. 2008); *D.R. Horton Inc.-New Jersey v. Dynastar Dev., L.L.C.*, No. MER-L-1808-00, 2005 WL 1939778, at \*31 (N.J. Super. Ct. Law Div. Aug. 10, 2005); *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323, 328 (Wyo. 2002); 2 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 12:3 (2012), *available at* Westlaw.

<sup>121</sup> *See, e.g.*, *DeWitt Truck Brokers*, 540 F.2d at 687.

<sup>122</sup> *See, e.g.*, Robert W. Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 989–90 (1971).

<sup>123</sup> Franklin A. Gevurtz, *Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil*, 76 OR. L. REV. 853, 866–67 (1997) (explaining that courts invoke the defendant's failure to observe corporate meeting formalities as a make-weight in order to support a decision to pierce justified by other facts). Admittedly, even if the significance of so-called corporate formalities in piercing cases is the equivalent of “an old wives’ tale,” its frequent mention might lead to the perception of its significance among attorneys and parties choosing in which state to form an LLC, and so a statutory provision stating that failure to observe meeting formalities in an LLC will not be grounds for piercing could figure into decisions in which state to form LLCs despite the lack of necessity for the provision. *Id.* at 867. In this instance, however, the difference between states would be a matter of legal infrastructure (clarity of law) as opposed to substantive protection of creditors (implicating race to the bottom concerns).

supposedly helpful provisions in some states, such as California,<sup>124</sup> did such a poor job that the provisions actually create an argument that the failure to follow meeting formalities might, under some circumstances, become grounds to pierce.<sup>125</sup>

In any event, it turns out that piercing may simply provide an inappropriate metric for testing the impact of creditor protection on choice of state of formation for LLCs. Because piercing is a common law doctrine applied by courts in a highly fact-specific and opaque manner,<sup>126</sup> it may be difficult to document state-by-state differences, even if they exist. While some scholars have compared the percentage of decisions in each jurisdiction in which the plaintiff succeeds rather than fails to pierce the corporate veil,<sup>127</sup> it is uncertain whether this reflects different proclivities toward piercing or whether it simply reflects factual variations in often small samples of decided cases. Besides, it is not clear that piercing the veil of limited liability comes within the internal affairs rule or, instead, whether the law of the jurisdiction in which the debt occurred governs this question.<sup>128</sup> The latter approach would, of course, render piercing irrelevant to the choice of state of formation.

Given such difficulties with using piercing as a variable, K&R focused on provisions in LLC statutes that impacted the rights, not of the LLC's creditors, but of creditors of the LLC's owners.<sup>129</sup> Specifically, they looked at provisions which prevented such creditors from reaching the assets of the LLC or obtaining the decisional rights regarding firm management or dissolution that the debtor-owner had possessed in the firm.<sup>130</sup> Still, while the law governing the rights of the members' creditors may not be as amorphous as the doctrine of

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<sup>124</sup> CAL. CORP. CODE § 17101(b) (West 2011).

<sup>125</sup> The California statute states that the failure to observe meeting formalities will not be grounds for piercing unless the LLC agreement calls for meetings, thereby creating a negative pregnant that the failure to hold meetings called for in an LLC agreement can be grounds to pierce. *E.g.*, Franklin A. Gevurtz, *California's New Limited Liability Company Act: A Look at the Good, the Bad, and the Ambiguous*, 27 PAC. L.J. 261, 299–301 (1996).

<sup>126</sup> *E.g.*, Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 506–13 (2001).

<sup>127</sup> *E.g.*, Peter B. Oh, *Veil-Piercing*, 89 TEX. L. REV. 81, 114–23 (2010).

<sup>128</sup> *Compare* *Realmark Inv. Co. v. American Fin. Corp.*, 171 B.R. 692, 695 (N.D. Ga. 1994) (applying law of state of incorporation), *with* *Abu-Nassar v. Elders Futures Inc.*, No. 88 Civ. 7906 (PKL), 1991 WL 45062, at \*4 (S.D.N.Y. Mar. 28, 1991) (finding it unclear if law of state of incorporation applies to piercing claim).

<sup>129</sup> Kobayashi & Ribstein, *supra* note 63, at 106–07.

<sup>130</sup> *Id.* For an example of such a provision, see DEL. CODE ANN. tit 6, § 18-703 (West 2012).

piercing, subtle variations in statutory language<sup>131</sup> and context-driven judicial decisions<sup>132</sup> seemingly leave the scope of these rights unsuited to the simple divisions and grouping necessary for a statistical correlation study.

The variables in the D&S study involving minority investor protection and managerial liability, because of their attention-grabbing result, call for the most attention. D&S reduce the highly complex subjects of minority investor protection and managerial liability in LLCs to five criteria, which they then apply on a simple binominal scale.<sup>133</sup> The criteria are the rights of the owners to cash out either under the default rule or through a statutory oppression remedy, the ability of the majority to force out the minority by dissolving the LLC, the standard of culpability for LLC managers under the duty of care, and the ability to waive liability of LLC managers for breaching their duty of care.<sup>134</sup>

Long experience with closely held corporations suggests that D&S were on the right track in considering that the ability of minority owners to cash out the minority's investment is a highly important protection of the minority in a non-publicly held business. Minority owners of a nonpublic company lack the ability of dissatisfied minority shareholders in a public corporation to liquidate their investment at any time by selling in an established market. At the same time, the history of closely held corporations is a tale of majority shareholders frequently exploiting the majority's power by curbing the dividends, or any other money, received by minority shareholders from the corporation; all the while, the majority shareholders continue to enjoy income from the corporation in the form of salaries and perquisites.<sup>135</sup> The ability of the minority to force redemption by the company at fair value is a potentially important guarantee against such an effort to squeeze the minority out from enjoying any benefit from the minority's ownership in the company

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<sup>131</sup> *E.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 120, § 7:8, app. at 7-9.

<sup>132</sup> *E.g.*, *In re Albright*, 291 B.R. 538, 541-42 (Bankr. D. Colo. 2003) (holding that bankruptcy trustee of sole member of LLC obtained management rights in LLC despite charging order as exclusive remedy provision); *Olmstead v. Fed. Trade Comm'n*, 44 So. 3d 76, 83 (Fla. 2010) (holding that a charging order is not an exclusive remedy); *Delta Dev. & Inv. Co. v. Hsiyuan*, No. 47192-9-I, 2002 WL 31748937, at \*16 (Wash. App. Dec. 9, 2002) (concluding that a constructive trust is not subject to limitations imposed on charging orders).

<sup>133</sup> *Dammann & Schündeln*, *supra* note 62, at 8-13.

<sup>134</sup> *Id.*

<sup>135</sup> *E.g.*, 1 O'NEAL & THOMPSON, *supra* note 55, §§ 2:01-2:20

either through distributions or the ability to sell in an established market.<sup>136</sup>

A problem, however, arises when we look at the specific variables D&S use to address the minority's ability to force a cash-out. First, they look to whether the LLC statute contains a provision allowing, as a default rule, withdrawal by LLC members (owners) and receipt of the fair value of the members' interest.<sup>137</sup> Such a default rule can be very useful for unsophisticated owners of an LLC, who are unlikely to anticipate the danger of a squeeze-out until it happens and leaves them with an illiquid investment and no distributions.<sup>138</sup> On the other hand, owners who do not anticipate the danger of an illiquid investment obviously will not choose a state in which to form their LLC based on a default rule that protects them from a hazard they fail to recognize. At the same time, owners who do want the right to cash out at fair market value can put this right in the LLC agreement<sup>139</sup> rather than find a state of formation with this as the default rule. Conversely, parties who anticipate being majority owners and want to avoid granting withdrawal rights to the minority can accomplish their goal by placing in the LLC agreement a provision denying the right of withdrawal, even if they formed the LLC in a state with withdrawal rights as the default rule.<sup>140</sup> In other words, anyone who is concerned enough about the issue to make this grounds for choosing the state of formation for the LLC really does not need to worry about the default rule because they can include desired terms in the LLC agreement.<sup>141</sup>

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<sup>136</sup> E.g., J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977).

<sup>137</sup> Dammann & Schündeln, *supra* note 62, at 9–10.

<sup>138</sup> See, e.g., Laurel Wheeling Farrar & Susan Pace Hamill, *Dissociation from Alabama Limited Liability Companies in the Post Check-the-Box Era*, 49 ALA. L. REV. 909, 931 (1998).

<sup>139</sup> See, e.g., DEL. CODE ANN. tit. 6, §§ 18-603, -604 (West 2012) (right to resign and obtain fair value for member's interest only exists if LLC agreement so provides); CAL. CORP. CODE § 17252(a) (West 2011) (unless the articles of organization or written operating agreement provide otherwise, a member withdrawing from an LLC is not entitled to payment for the member's interest in the limited liability company).

<sup>140</sup> E.g., MASS. ANN. LAWS ch. 156C, §§ 32, 36 (LexisNexis 2005) (while the LLC agreement cannot eliminate a member's right to resign, the LLC agreement sets what the resigning member is entitled to receive from the company); MO. ANN. STAT. §§ 347.103(2), .121(1) (West 2008); N.M. STAT. ANN. § 53-19-37(A), (C) (West 2011) (unless LLC otherwise provides, a member has the right to withdraw and receive fair market value).

<sup>141</sup> It is also worth noting that withdrawal rights are not the only way to protect minority owners from being squeezed out of any economic benefit of ownership.

In the 2010 iteration of their study, D&S added a variable based upon whether the state's LLC act enables the minority to seek dissolution based upon oppression.<sup>142</sup> Since the minority's ability to force dissolution or a buyout under such provisions depends upon convincing the court that the majority has engaged in oppression or the like,<sup>143</sup> the protection provided by such provisions is less automatic than a no-fault ability to withdraw and receive fair value under an LLC agreement or a statutory default rule. Still, the oppression term may have more impact on choice of state of formation than the default rule regarding withdrawal—at least for organizers seeking to avoid having their LLC subject to the oppression remedy—because it is uncertain whether an LLC agreement can waive the oppression remedy in states where it exists by statute.<sup>144</sup> A problem, however, is that D&S's effort to reduce the oppression remedy to a simple binominal variable suitable for correlation testing significantly oversimplifies the law in this area. Not only do the statutes grouped together by D&S differ in potentially significant language,<sup>145</sup> but judicial decisions applying these statutes

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Provisions either in an LLC agreement or in statutory default rules that prevent majority owners or managers from obtaining money from the company (such as through salaries) not shared proportionately with, or approved by, the minority also deter the majority from cutting distributions shared by all owners. Franklin A. Gevurtz, *Squeeze-outs and Freeze-outs in Limited Liability Companies*, 73 WASH. U. L.Q. 497, 505–06, 510–11 (1995). Hence, a state with a default rule preventing the majority from setting its own salary, e.g., CAL. CORP. CODE § 17004(b) (West 2011), may provide roughly the same degree of minority investor protection as a state with a default rule giving the minority withdrawal rights.

<sup>142</sup> Dammann & Schündeln, *supra* note 62, at 8–9.

<sup>143</sup> E.g., *S-S, LLC v. Merten Bldg. Ltd. P'ship*, No. 292943, 2010 WL 4679524, at \*6 (Mich. Ct. App. Nov. 18, 2010), available at [http://coa.courts.mi.gov/documents/OPINIONS/FINAL/COA/20101118\\_C292943\\_32\\_292943.OPN.PDF](http://coa.courts.mi.gov/documents/OPINIONS/FINAL/COA/20101118_C292943_32_292943.OPN.PDF) (finding that the plaintiffs failed to prove oppressive conduct).

<sup>144</sup> Compare *Sivsa Entm't v. World Int'l Network*, No. B164377, 2004 WL 1895080, at \*7 (Cal. Ct. App. Aug. 25, 2004) (in an opinion that is not published and therefore not citable under California rules, the court held the statutory dissolution provision is not subject to waiver), with *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, No. 3803-CC, 2008 WL 3846318, at \*3 (Del. Ch. Aug. 19, 2008), available at <http://www.courts.state.de.us/opinions/download.aspx?ID=110340> (enforcing waiver). By contrast, organizers who wish to provide the oppression remedy presumably can create the equivalent in the LLC agreement, even if they form their LLC under the law of a state whose LLC statute does not contain such a provision.

<sup>145</sup> Dammann & Schündeln, *supra* note 62, at 8–9. *Kent Tillman, LLC v. Tillman Constr. Co.*, No. 263232, 2006 WL 143289 (Mich. Ct. App. Jan. 19, 2006), available at [http://coa.courts.mi.gov/documents/OPINIONS/FINAL/COA/20060119\\_C263232\\_44\\_263232.OPN.PDF](http://coa.courts.mi.gov/documents/OPINIONS/FINAL/COA/20060119_C263232_44_263232.OPN.PDF), illustrates the importance of statutory differences. There, the court affirmed dismissal of a claim brought under a provision in Michigan's LLC statute that

complicate the situation further.<sup>146</sup> Moreover, provisions in LLC statutes allowing judicially ordered dissolution on grounds borrowed from partnership law<sup>147</sup> occasionally might pick up some cases of oppressive conduct<sup>148</sup>—thereby further muddying the significance of the distinctions which D&S seek to draw between jurisdictions whose LLC statute does and does not contain an explicit provision allowing dissolution for oppression.

The flip problem from the majority owner trapping the minority in an illiquid investment not producing any distributions (the “squeeze-out”) is the majority forcing the minority to sell out (the “freeze-out”).<sup>149</sup> It is therefore not surprising that D&S consider LLC laws impacting the prospect for a freeze-out in their variables concerning minority investor protection. What is curious, however, is the specific law they chose as the sole measure of this prospect. D&S chose to focus on the presence or absence of a default rule in the LLC statute allowing dissolution of the LLC by majority vote.<sup>150</sup> It is true, as I stated in an article D&S cited in support of this variable,<sup>151</sup> that a majority owner could exercise a power to dissolve the LLC with the plan of capturing the business in the ensuing liquidation of the company—thereby freezing out the minority.<sup>152</sup> Yet, some LLC statutes (notably including Delaware’s) provide easier avenues, which D&S ignore, for freezing out minority owners. The freeze-out through

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provided relief in cases of “oppressive conduct.” *Id.* at \*4. The statute stated, however, that acts consistent with the operating agreement were not oppressive, and the complaining member’s expert conceded that the challenged acts, while unfair, were consistent with the agreement. *Id.* Since squeeze-outs by the majority presumably would commonly consist of taking advantage of powers the majority enjoys under the agreement (such as setting distributions) in ways the minority did not anticipate, this language radically reduces the scope of the oppression remedy.

<sup>146</sup> For a discussion of the cases, see 1 RIBSTEIN & KEATINGE, *supra* note 120, § 11:5 n.25.

<sup>147</sup> *E.g.*, DEL. CODE ANN. tit. 6, § 18-802 (West 2012); N.Y. LTD. LIAB. CO. LAW § 702 (McKinney 2007).

<sup>148</sup> Compare *Kirksey v. Grohmann*, 754 N.W.2d 825, 831 (S.D. 2008) (ordering dissolution of an LLC pursuant to a statutory provision allowing dissolution in situations in which it is not reasonably practical to carry on in conformity with the agreement, when two of the four members exercised all the power in the LLC and ran the LLC for their own benefit), with *Gidwitz v. Lanzit Corrugated Box Co.*, 170 N.E.2d 131, 138 (Ill. 1960) (ordering dissolution of a corporation for oppression when fifty percent faction ran the corporation without regard for the other fifty percent owners).

<sup>149</sup> *E.g.*, *Gevurtz*, *supra* note 141, at 498 (defining squeeze-out and freeze-out).

<sup>150</sup> *Dammann & Schündeln*, *supra* note 62, at 10–11.

<sup>151</sup> *Id.* at 11; *Gevurtz*, *supra* note 141, at 525–28.

<sup>152</sup> *Gevurtz*, *supra* note 141, at 525–28.

dissolution requires the majority to outbid the minority for the company's assets in the ensuing liquidation—perhaps because the majority has a financing advantage or because the majority appropriates some value attached to the business (such as goodwill or customers) without paying for it<sup>153</sup>—otherwise, the majority could find itself frozen out. Even if the majority acquires the business, there are potentially undesirable side effects associated with dissolution as a means of affecting a freeze-out, as the majority will need to refinance the debts of the LLC<sup>154</sup> and might lose the value of any contracts that terminate upon the LLC's dissolution.<sup>155</sup> A slicker approach to freezing out the minority, available under some LLC statutes including Delaware's,<sup>156</sup> is a freeze-out merger with a shell company (such as another LLC set up solely for this purpose).<sup>157</sup> This avoids the prospect that the majority might not end up with the business in the liquidation sale, as well as the burdens of refinancing debts and potentially losing contracts entailed by undertaking a dissolution and liquidation.<sup>158</sup>

In any event, these are default rules that parties can contract around.<sup>159</sup> Hence, their main hazard is to unsophisticated parties who do not recognize the impact until the majority exploits a power, which the majority may not have even realized it possessed at formation, to kick out the minority. Such parties, however, will not choose a state of formation based upon a default rule, the impact of which they do not appreciate. By contrast, a minority investor who wants to avoid the danger of a freeze-out can contract to limit the ability of the majority to dissolve at will or merge the LLC just as easily as insisting on forming the LLC in a state whose default rules do not allow these actions by majority vote. A majority owner who wants the freeze-out option could ask for provisions in the LLC agreement

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<sup>153</sup> *E.g.*, Franklin A. Gevurtz, *Preventing Partnership Freeze-Outs*, 40 MERCER L. REV. 535, 541–42 (1989).

<sup>154</sup> *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-804(a)–(b) (West 2012) (requiring payment of firm debts on dissolution); CAL. CORP. CODE § 17353(a) (West 2011) (same).

<sup>155</sup> *See, e.g.*, *Fairway Dev. Co. v. Title Ins. Co.*, 621 F. Supp. 120, 124 (N.D. Ohio 1985) (contract terminated on dissolution of partnership).

<sup>156</sup> DEL. CODE ANN. tit. 6, § 18-209.

<sup>157</sup> *E.g.*, Gevurtz, *supra* note 141, at 530–32.

<sup>158</sup> *E.g.*, GEVURTZ, *supra* note 27, at 349.

<sup>159</sup> *E.g.*, DEL. CODE ANN. tit. 6, § 18-209(b) (West 2012) (stating that, unless otherwise provided in the LLC agreement, a majority vote is sufficient to approve an LLC merger); *id.* § 18-801(a)(3) (stating that, unless otherwise provided in the LLC agreement, a two-thirds vote can dissolve the LLC).

allowing dissolution or merger by majority vote—or, even more directly, a provision that gives the LLC the right to redeem minority interests at the majority’s option—even if the parties form the LLC in a state having contrary default rules.<sup>160</sup> It is possible that majority owners might prefer that the freeze-out potential remain in default rules rather than in contract terms so as to attract less attention from potential minority investors. This assumes that merger or dissolution terms buried in a contract are more likely to alert the minority to the freeze-out danger than would such provisions found in state law default rules. In any event, the attempt to slip things past the minority through selecting default rules rather than contract terms would entail a very subtle calculation, and so perhaps is not common enough to be statistically significant in a correlation study of thousands of LLCs—even though it would be significant to the minority in those cases in which such shenanigans occur.

Turning to fiduciary duties and managerial liability, D&S focus on the duty of care.<sup>161</sup> This seems odd insofar as the duty of care, in contrast to the duty of loyalty, appears not to be that frequently litigated,<sup>162</sup> or likely to produce liability,<sup>163</sup> in nonpublic, noncorporate businesses. Hence, provisions in LLC acts allowing LLC agreements to modify liability for breaching the duty of care—which D&S use as one of their testing variables<sup>164</sup>—would seem less important than provisions in LLC acts, like Section 18-1101 of Delaware’s law, that allow much broader waivers of fiduciary duties, including the duty of loyalty.<sup>165</sup> The other variable regarding the duty of care used by D&S is whether or not the state’s LLC statute

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<sup>160</sup> *E.g.*, ARIZ. REV. STAT. ANN. § 29-752(B) (2011) (unanimous vote for mergers subject to contrary LLC agreement); MICH. COMP. LAWS ANN. § 450.4702 (West 2012) (mergers on unanimous vote or vote called for in LLC agreement); *id.* § 450.4801 (dissolve on unanimous vote or the vote called for by LLC agreement); WYO. STAT. ANN. § 17-25-108 (2012) (unanimous vote for dissolution unless otherwise provided); *id.* § 17-25-111 (same for mergers).

<sup>161</sup> Dammann & Schündeln, *supra* note 62, at 12.

<sup>162</sup> *E.g.*, Miller, *supra* note 57, at 574–75 (stating that fiduciary duty litigation in LLCs overwhelmingly involves the duty of loyalty rather than care); Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?*, 30 DEL. J. CORP. L. 343, 370 (2005) (discussing the lack of authority on partners’ duty of care, rather than loyalty, prior to the RUPA, and the lack of duty of care cases under either the RUPA or the limited liability company statutes).

<sup>163</sup> Miller & Rutledge, *supra* note 162, at 373–79 (discussing the deferential standards generally applied by courts in dealing with the duty of care in the noncorporate context).

<sup>164</sup> Dammann & Schündeln, *supra* note 62, at 12–13.

<sup>165</sup> *E.g.*, DEL. CODE ANN. tit. 6, § 18-1101 (West 2012).

contains a specific provision defining breach of the duty of care to equal gross negligence or some other heightened requirement.<sup>166</sup> Such provisions, however, may do little more than codify the otherwise existing judicial understanding of the duty of care in the business-management context.<sup>167</sup> Moreover, even if such provisions do more than codify the existing case law, it is unclear whether they, in fact, increase or decrease the often uncertain standard for culpability in the absence of a statutory definition.<sup>168</sup> Hence, it is difficult to interpret what any correlation regarding this variable is saying.

Rather than limiting their testing to provisions allowing waiver of the duty of care, K&R use statutes allowing complete waiver of fiduciary duties as their variable for provisions that protect managers from liability (but which K&R prefer to view as one measure of flexibility available under the statute).<sup>169</sup> One issue here, however, is whether this variable groups together provisions whose impact on choice of state of formation is different, or separates provisions whose impact on choosing the state of formation is the same. For example, suppose those choosing where to form LLCs do not draw the same line as K&R in deciding what provisions allow or do not allow complete waivers. Moreover, suppose in the minds of those deciding in which state to form LLCs, one state's (Delaware's) provision allowing complete waivers enjoys an advantage over other states with the same statutory language because of more favorable judicial interpretations.<sup>170</sup> In any of these events, K&R's testing will understate the statistical significance of the impact of provisions allowing waivers.

As two other measures of "flexibility," K&R use the availability of inter-business-form ("inter-species") mergers under provisions that allow mergers of LLCs with corporations and the like, and the ability

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<sup>166</sup> Dammann & Schündeln, *supra* note 62, at 12.

<sup>167</sup> *E.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 120, § 9:2; Miller & Rutledge, *supra* note 162, at 369.

<sup>168</sup> *E.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 120, § 9:2; Miller & Rutledge, *supra* note 162, at 369.

<sup>169</sup> Kobayashi & Ribstein, *supra* note 63, at 104–05.

<sup>170</sup> *E.g.*, H. JUSTIN PACE, CONTRACTING OUT OF FIDUCIARY DUTIES IN LLCs: DELAWARE WILL LEAD, BUT WILL ANYONE FOLLOW? 7 (2010), available at <http://ssrn.com/abstract=1786876> ("[T]he enforceability of waivers of fiduciary duties by LLC members remains very much in question in most of th[e] states [categorized by the Ribstein & Keatinge treatise on LLCs as having provisions equivalent to Delaware's act] due to negative LLC case law, variations in the statutory text of individual states, and negative limited partnership . . . law.").

to admit members (owners) into the LLC, despite those members having made no contributions to, and having no economic interest in, the company.<sup>171</sup> The inter-species merger is a potentially handy device that allows, with somewhat greater convenience, changes of business form and business combinations that otherwise can occur through a sale of assets or an acquisition of interests followed by dissolution.<sup>172</sup> Bringing in members who make no contribution and lack any economic interest can be a technique for preventing dissolution of LLCs at the behest of creditors who have seized all the interests of members having economic interests.<sup>173</sup> Hence, this variable may go to the creditor protection hypothesis.

K&R add one additional hypothesis for what motivates an LLC's state of formation choice; whether the state engages in innovation in its law.<sup>174</sup> The problem here is to decide what to measure as "innovation." After all, a new and unique provision in a state's LLC law might be a brilliant innovation or a poorly conceived idiosyncratic notion, or both, depending upon who one is asking. K&R use adoption of the "series LLC" as their measure of innovation.<sup>175</sup> In a series LLC, the LLC agreement can divide the firm into compartments, each with its own members, managers and interests, and each of which can create separate rights and duties with regard to specific property and liabilities.<sup>176</sup> While the series LLC is perhaps innovative, a positive correlation between LLC state of formation statistics and states allowing series LLCs may not show any advantage for innovation per se, as opposed to the particular desirability of series LLCs.

This, in turn, raises the question of why series LLCs may be desirable. In fact, even without such statutory provisions, LLC agreements could have created such a compartmentalized management structure and division of interests, which would govern the rights and obligations of the LLC's members vis-à-vis each

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<sup>171</sup> Kobayashi & Ribstein, *supra* note 63, at 105.

<sup>172</sup> *E.g.*, PROTOTYPE LTD. LIAB. CO. ACT § 1201 cmt. (1992).

<sup>173</sup> *See, e.g., In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003) (in deciding that the trustee administering the bankruptcy estate of the sole member of an LLC could obtain management rights and dissolve the LLC, the court emphasized that the result would be different if there were other members in the LLC).

<sup>174</sup> Kobayashi & Ribstein, *supra* note 63, at 105–06.

<sup>175</sup> *Id.*

<sup>176</sup> *E.g.*, DEL. CODE ANN. tit. 6, § 18-215 (West 2012).

other.<sup>177</sup> The trick is to bind third party creditors of the LLC to an arrangement limiting what assets of the firm they can reach. In the absence of series LLCs, this would have entailed the formation of a multitude of separate LLCs—something persons operating LLCs commonly do.<sup>178</sup> The concern, however, is that courts might pierce the veil of limited liability between closely related LLCs, and, accordingly, the goal of series LLCs is to reduce this possibility.<sup>179</sup> Hence, a positive correlation involving series LLCs and state of formation choices may show more about creditor protection as a selection factor than it does about innovation per se as a selection factor. Moreover, this advantage of series LLCs may be more apparent than real. Not only do the statutory provisions authorizing series LLCs require actions<sup>180</sup> seemingly designed to prevent the sort of mingling of assets that often provides the ground to pierce the veil between commonly owned companies,<sup>181</sup> but one suspects that a court would still pierce the veil in the event of fraud or the like.<sup>182</sup> Hence, it is not clear how much broader significance one can draw from any lack of correlation between series LLCs and state of formation statistics.

Beyond these specifics, the K&R study raises one overarching question: the study found virtually no statistically significant correlation to any tested factor other than its measures of judicial quality.<sup>183</sup> However, we know that many larger LLCs choose to form under Delaware law even though their principal places of business are in other states. Something must motivate this. Are we to conclude that the only significant motivation is judicial quality? Before accepting such a result, one should ask whether there are other possible motivating factors not tested by K&R, or whether the correlation

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<sup>177</sup> *E.g.*, *id.* §§ 18-302, -404, -503, -504 (allowing for classes of members and managers and allocation of financial rights among members however the LLC agreement provides); CAL. CORP. CODE § 17005 (West 2011) (LLC operating agreement governs rights of members with limited exceptions).

<sup>178</sup> *See, e.g.*, REVISED UNIFORM LIMITED LIABILITY COMPANY ACT prefatory note (2006) (“Given the availability of well-established alternate structures (e.g., multiple single member LLCs, an LLC ‘holding company’ with LLC subsidiaries), it made no sense for the Act to endorse the complexities and risks of a series approach.”).

<sup>179</sup> *E.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 120, § 4:17.

<sup>180</sup> *E.g.*, DEL. CODE ANN. tit. 6, § 18-215(b) (West 2012) (requiring each series in a series LLC to keep separate records and to hold separately its assets).

<sup>181</sup> *See, e.g.*, *Sea-Land Services, Inc. v. Pepper Source*, 993 F.2d 1309 (7th Cir.1993).

<sup>182</sup> *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 120, § 4:17 (courts should retain the power to police fraud despite series LLC).

<sup>183</sup> Kobayashi & Ribstein, *supra* note 63, at 136.

methodology employed by K&R was insufficiently sensitive to detect the impact of the possible motivating factors they did test. In other words, the very narrowness of the bottom-line result reached by K&R cries out for a comparison with a study using a different methodology.

### III

#### THE BUSINESS ATTORNEY SURVEY

##### *A. Methodology*

Given the correlation studies' limitations, what would be useful is an additional study under a methodology that can accomplish several things. It should provide grounds, beyond simply a theoretical hypothesis, for determining whether a correlation does in fact stem from causation, or, alternately, whether a lack of correlation supporting a hypothesis might stem simply from limitations in the correlation study. It should provide a comprehensive set of hypotheses to ensure correlation testing for any reasonably possible motivational factor. It also should provide insights to help ensure that the specific factual variables tested by the correlation study in fact measure the motivational factors of each hypothesis.

Surveying actual decision makers in the field is a methodology to accomplish all of these objectives.<sup>184</sup> If real decision makers in the field report reasons for their actions which match a hypothesis tested by a correlation study, then there is a much stronger basis to conclude that a statistically significant correlation between the tested hypothesis and state of formation statistics reflects causation. Meanwhile, a contrary result in the survey should serve as a caution before reaching such a conclusion. Moreover, if the survey finds real decision makers report acting for reasons that do not generate a statistically significant correlation, then the lack of correlation might reflect limitations in the correlation study that, in turn, call for refining the correlation test. Beyond this, open ended questions to real decision makers in the field can produce a more comprehensive list of hypotheses regarding the motivating factors than relying just on the theoretical literature and the analysis of academics. Along similar lines, the answers of real decision makers in the field can check either

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<sup>184</sup> See, e.g., EARL BABBIE, *THE BASICS OF SOCIAL RESEARCH* 272–73 (2nd ed. 2002) (stating that survey research is probably the best method available for collecting original data used to describe a large population; once a survey is completed, secondary analysis can be conducted, using the data to answer questions that the original researcher did not focus on).

attributing undue significance to, or missing the significance of, specific factual variables as measures of the motivational hypotheses which otherwise may result from exclusive reliance on academic analysis. By broadening the range of hypotheses and refining the variables used to test the hypotheses, a survey of decision makers can allow those conducting statistical studies to improve their results. The statistical studies then can either confirm or raise questions as to whether the survey results were typical or idiosyncratic. In this manner, the different methodologies complement each other.

### 1. *The Sample*

The sample for this survey consists of business attorneys whose clients had formed LLCs. While such attorneys may not technically decide where to form the LLC, their advice to the client who makes the decision presumably will be highly influential if not decisive.<sup>185</sup> Even where the attorney's advice does not drive the decision, they presumably are in a position to hear the reasons for the client's state of formation choice.<sup>186</sup>

I found attorneys who were willing to participate in the survey through a number of different avenues. A variety of sources referred

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<sup>185</sup> See, e.g., Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 273 (1985).

<sup>186</sup> This obviously leaves out LLCs formed without the assistance of attorneys. While one normally assumes that such LLCs generally are smaller enterprises and tend to form under the law of the state of their principal place of business, it is possible that some might form under Delaware law. Several websites maintained by firms in the business of aiding the do-it-yourself crowd to form corporations or LLCs discuss the advantages and disadvantages of formation under Delaware law. E.g., *How to Select a State for Incorporation*, BIZFILINGS, <http://www.bizfilings.com/learn/which-state-incorporation.aspx> (last visited July 10, 2010); *Where to Form an LLC*, MYNEWCOMPANY.COM, <http://www.mynewcompany.com/whichstate.htm> (last visited July 10, 2010). Proving the adage that you get what you pay for, the free advice on these websites on the reasons to form one's business under Delaware law is muddled and often based upon erroneous understanding of the law. See *id.* These sites place considerable emphasis on the relative fees and taxes imposed by states on firms forming under the state's law, but then acknowledge the prospect that the state of the company's actual place of business may impose fees and taxes which offset the savings of forming in a low-fee or low-tax state. *Id.* So in the end, the whole discussion is just confusing. The sites tout the advantages of Delaware's Chancery Court, but then misconstrue the impact by suggesting the applicability of this advantage to claims brought against the company by outsiders such as consumers. *Id.* All of this suggests that seeking to divine the reasons for unrepresented parties choosing to form LLCs under Delaware law may turn into a study of mythology, rather than responses to actual differences.

many of these attorneys to me.<sup>187</sup> The largest group, however, consisted of attorneys who volunteered for the survey in response to a posting on a Listserv maintained by the Committee on LLCs, Partnerships and Unincorporated Entities of the Business Law Section of the American Bar Association.<sup>188</sup>

This sort of “convenience sampling” admittedly introduces the potential for selection bias relative to a survey based upon a completely random sample. This is especially the case in the group of attorneys who volunteered in response to the Listserv posting.<sup>189</sup> Not only might the nature of attorneys who volunteer, versus those who did not volunteer, introduce some selection bias, but the fact that these attorneys subscribe to a Listserv on LLCs and other unincorporated businesses might distinguish them from business attorneys who are less interested in LLCs and yet might aid clients in forming such entities. Indeed, during the course of the survey, a number of these attorneys told me of their leadership positions in their firm or in their state bar with respect to issues dealing with LLCs. On the other hand, this selection bias may create a sample more likely to correspond to the sort of attorneys whose clients form LLCs in Delaware, and, hence, are in a better position to give the reasons for that decision.

In any event, the surveyed attorneys represent a cross section both in terms of geography and in terms of the size of their law firms. Figure 1 presents the distribution among the states of the attorneys responding to the survey.<sup>190</sup> The sample includes attorneys practicing in twenty-three states. These states are in all regions of the country.

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<sup>187</sup> These sources included attorneys I knew, contacts through other law professors both at my school and others, working through my school’s career development office, contacts made through my school’s Board of International Advisors, and contacts through the California Bar Association’s Committee on Partnerships, LLCs and Unincorporated Entities.

<sup>188</sup> I am indebted to James Wheaton, Chair at the time of the Committee on LLCs, Partnerships and Unincorporated Entities of the Business Law Section of the American Bar Association, for this posting.

<sup>189</sup> Indeed, the referral sources were sufficiently eclectic to introduce a fair amount of random chance into the set of attorneys I found from referrals.

<sup>190</sup> The number appearing in each state on the map is the number of surveyed attorneys in each state; the darker the shading, the more surveyed attorneys were in the state.

FIGURE 1. Dispersion of surveyed attorneys by state

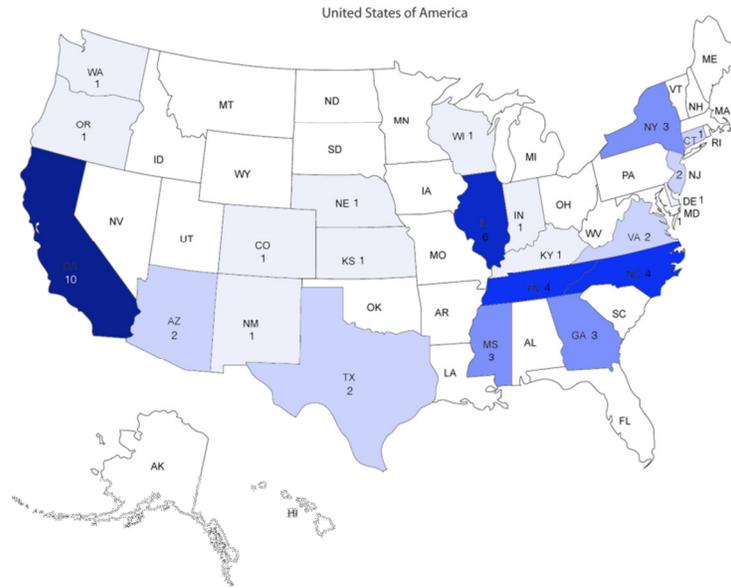
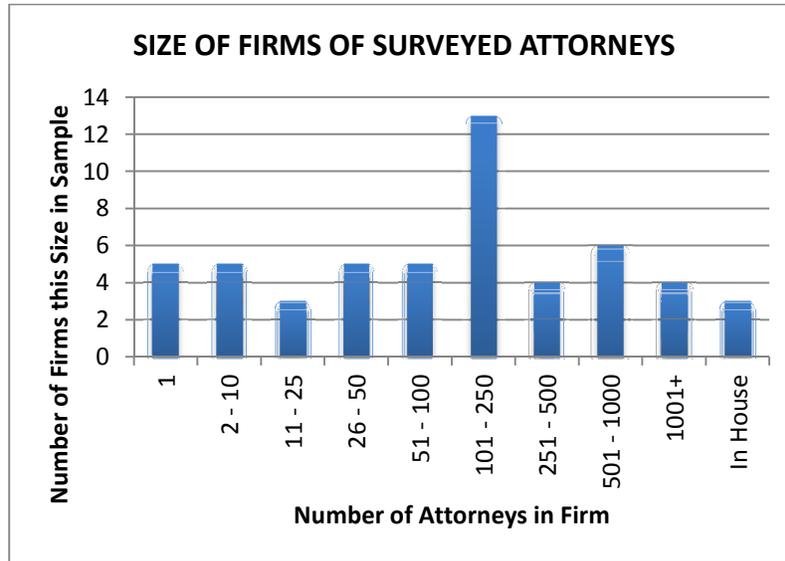


Figure 2 presents the distribution of the attorneys responding to the survey in terms of firm size. The firms ranged from sole practitioners to “American Lawyer top 100” law firms.

FIGURE 2.



A total of fifty-three attorneys responded to this survey.<sup>191</sup> This consisted of thirty-six interviews over the telephone or in person, and seventeen attorneys who responded to the survey in writing.<sup>192</sup> This

<sup>191</sup> As explained below, the final segment of the survey asked each attorney whether he or she had discussed state of formation choice for LLCs with other attorneys at his or her law firm or more generally. If so, the survey then asked each attorney whether he or she expected I would receive similar answers as given by the surveyed attorney in response to the survey if I talked with the other attorneys with whom the surveyed attorney had discussed this topic. Most of the surveyed attorneys reported that they had discussed the topic of LLC state of formation with other attorneys and that I would receive similar answers if I interviewed the other attorneys with whom the surveyed attorney had discussed the topic. Hence, this survey should represent the views of more than the fifty-three attorneys surveyed. When some of the surveyed attorneys reported that I might get different answers, the differences they mentioned generally went to likelihood of forming LLCs in a state other than the state of the LLC's principal place of business, rather than the reasons for this decision.

<sup>192</sup> In order to encourage maximum participation by allowing maximum convenience, I gave attorneys who indicated a willingness to participate a choice between the telephone interview and filling out the survey in writing. Of those who chose to respond in writing, ten filled out the survey while seven sent written comments in lieu of filling out the entire survey.

sample provides useful information to guide larger studies, rather than seeking to provide statistically significant results itself. Specifically, this sample should be sufficient to provide a broad set of hypotheses as to possible motivational factors for state of formation choices and to suggest factual variables to test those hypotheses. In addition, it should be sufficient either to suggest confirmation that a statistically significant correlation does reflect causation or to raise doubts on that score, as well as to warn when the failure to obtain a statistically significant correlation might reflect limitations of the correlation study. In short, this sample should be sufficient to guide statistically rigorous investigations toward more robust results.

## 2. *The Survey Questions*

The survey questions are found in the Appendix to this Article. These questions reflect not only academic literature on LLCs and state of formation choices, but also the results of an open-ended pilot interview I conducted with an attorney who has aided clients in forming numerous LLCs and was gracious enough to spend considerable time in an unstructured discussion, as well as serving later as the “beta test” on the first draft of the survey questions. I conducted all of the interviews myself in order to exercise judgment in asking follow-up questions or even engaging the surveyed attorneys in extended discussion when they were willing, rather than using the survey questionnaire as a strict script from which the interview could not depart.<sup>193</sup>

The first group of questions in the survey sought some basic background information. This begins, of course, by confirming that the attorney has advised clients in forming LLCs.<sup>194</sup> A negative answer to this question would, needless to say, result in terminating the interview; but the selection process was such that this did not happen. The next question sought to identify the clients’ expected roles in the newly formed LLCs—in other words, did the clients expect to be all the owners, majority owners, managers, or minority

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<sup>193</sup> Despite my willingness to depart from the script to ask follow-up questions, there are numerous points (reflected in the data reported in this Article) at which I decided not to ask a follow-up because I concluded it would have unduly taxed the patience of the attorney I was interviewing.

<sup>194</sup> Information about the location of the attorney and the identity of his or her law firm came from the communication (almost always by email) lining up the interview or written survey.

investors?<sup>195</sup> This established the predicate for later questions which asked the attorney about the impact of the client's expected role on the state of formation. As discussed above,<sup>196</sup> the assumption that those expecting to be majority owners or managers choose where to form the entity and do so with an eye toward laws reducing minority investor protection or prospects for managerial liability provides the basis for the race to the bottom thesis. For similar reasons, the third question in this series asked whether the LLC intended to solicit outside investors following formation.

The next group of questions looked at the basic facts about the choice of state of formation. These include asking in what states the clients' LLCs had their principal places of business, whether any clients formed their LLCs under the law of a state other than the states in which the companies had their principal places of business, and, if so, in what states. The third question in this group was the central question for the survey in that it asked the reasons for forming in states other than the LLCs' principal places of business. This sort of open-ended question employs a key advantage of the survey methodology over the correlation studies, as it does not depend upon the researcher already having thought of the answer, and so allows answers that suggest hypotheses for further testing.

The next four questions asked whether four general factors influenced the decision to form the LLC in a state other than the state of the LLC's principal place of business. These included: (1) the state of the LLC's principal place of business; (2) the size of the LLC's business; (3) the client's expected role in the LLC; and (4) whether the LLC intended to raise money from outside investors. The last two of these factors go to the race to the bottom thesis, as just discussed. By contrast, the first factor simply sought information on whether some states are more successful than others in retaining in-state formation for LLCs whose principal place of business is in the state. The second factor sought to confirm the D&S finding (and the normal intuition) about the impact of firm size on the decision to form LLCs outside the state of their principal place of business.

The next two groups of questions probed, in more detail, statutes and judicial infrastructure as possible grounds for selecting the LLC's

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<sup>195</sup> The survey also listed the possibility of representing the LLC as opposed to its prospective members or managers (*see, e.g.*, GEVURTZ, *supra* note 27, at 29 (discussing the concept of representing the entity to be formed rather than the parties expecting to be the owners)), and any other possible client.

<sup>196</sup> *See supra* text accompanying note 11.

state of formation. There were four basic questions about statutes. The first two asked generally whether there were any statutory provisions that made it more or less likely that clients would form their LLCs in a state with this statutory provision. Again, such open-ended questions, while able to prompt responses potentially overlooked by the surveyed attorneys in the global question as to why clients formed their LLCs in a state other than that of the company's principal place of business, were still such as to elicit responses that did not depend upon the researcher already having thought of which statutory provisions would be important.

The other questions about LLC statutes looked at specific provisions in Delaware's LLC act. These provisions were Section 18-1101, which sets out the policy of the Delaware LLC act as favoring maximum freedom of contract and allows the LLC agreement to eliminate all fiduciary and other duties except for the duty of good faith and fair dealing, and Section 18-209, which allows the majority in ownership either to amend the agreement or to kick out the minority through a merger with a shell entity, barring an explicitly contrary provision in the LLC agreement.<sup>197</sup>

Based both upon the pilot interview I conducted before developing the survey questionnaire and the views of various authorities,<sup>198</sup> I already had reason to believe that Section 18-1101 might be an important factor in the decision to form LLCs under Delaware law. Moreover, as a matter of normative interest, both Section 18-1101 and Section 18-209 might test the race toward laxity thesis. Indeed, because of the advantages discussed earlier<sup>199</sup> of the freeze-out merger over the freeze-out effectuated through dissolution and liquidation, as well as because of the power this provision gives to the majority to amend the LLC agreement in a manner that favors the majority at the expense of the minority, Section 18-209 seems far more significant than the majority dissolution powers tested by D&S.

A key difference between Sections 18-1101 and 18-209 is that Section 18-209 establishes a default rule that members in Delaware LLCs can contract around and that members in non-Delaware LLCs can contract for, while Section 18-1101 changes what otherwise presumably are mandatory fiduciary duty rules into default rules subject to contractual waiver—a result that parties can only achieve

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<sup>197</sup> *E.g.*, Gevurtz, *supra* note 141, at 511–12, 530–32.

<sup>198</sup> *See, e.g.*, *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 290–92 (Del. 1999) (touting freedom of contract under Delaware's LLC act as a reason for its popularity).

<sup>199</sup> *See supra* text accompanying notes 153–58.

by forming in a state with the same law. As such, for the reasons discussed above,<sup>200</sup> one would expect Section 18-1101 to have a far greater impact on choice of state of formation than Section 18-209. Still, if one is going to ask about a default rule, Section 18-209 seemed an interesting one to choose. This is not only because the section creates rather strong majority-favoring powers, but also because the section creates these powers in a hidden manner. On its face, Section 18-209 seems simply to deal with combining firms through mergers. Only someone familiar with freeze-out mergers or the use of mergers in the corporate context to alter shareholder rights<sup>201</sup> is likely to recognize the power Section 18-209 grants the majority to kick out the minority or alter the minority's rights.<sup>202</sup> To top it off, avoiding this default rule requires an "explicitly contrary" provision in the LLC agreement—meaning that provisions in an LLC agreement demanding unanimous vote for expulsion or for amending the agreement might not preclude the majority from using a merger to freeze out the minority or amend the LLC agreement if the expulsion or amendment provisions in the LLC agreement did not specifically refer to mergers. Hence, if there are majority owners trying to use default rules to slip in powers that they suspect minority investors would reject if placed in the LLC agreement, Section 18-209 seems to be a good candidate.

The specific questions regarding Sections 18-1101 and 18-209 asked if these sections impacted the decision of clients to form their LLCs in Delaware and, if so, whether this depended upon the expected role of the client in the LLC. Again, the client role question is to test a key assumption underlying the race to the bottom thesis. In addition, the questions elicited information on whether these provisions impacted the language of LLC agreements. With respect to Section 18-1101, this included asking whether the agreements for the clients' Delaware LLCs contained waivers of fiduciary or other duties and whether the same language occurs in the agreements governing the clients' non-Delaware LLCs. Along somewhat similar lines, the questions into the impact of Section 18-209 sought to determine whether the clients' Delaware LLCs contracted out of Section 18-209's default rule by limiting the majority's power to merge, freeze-out the minority, or amend the contract, or whether agreements

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<sup>200</sup> See *supra* text accompanying notes 159–60.

<sup>201</sup> See, e.g., *Bove v. Cmty. Hotel Corp. of Newport, R.I.*, 249 A.2d 89 (R.I. 1969).

<sup>202</sup> E.g., *Gevurtz*, *supra* note 141, at 534.

governing the clients' non-Delaware LLCs created the equivalent to Section 18-209's default rule. The goal is to go beyond looking at what motivated selection of Delaware as the state of formation for LLCs and at least begin an inquiry into the impact, including the potentially unintended impact, of this choice.

If the surveyed attorney included the superiority of the Delaware judiciary in his or her reasons for forming LLCs in Delaware, I asked the attorney a group of questions designed to ascertain the sources by which the attorney came to view the quality of Delaware's judiciary as superior in a context relevant to LLCs.<sup>203</sup> The questions asked about the attorney's experience, or the experience of other lawyers known to the attorney, in litigation in the courts of Delaware or in other states, which involved the internal affairs of noncorporate entities (such as LLCs) or nonpublic corporations. The questions also asked the attorney about judicial opinions he or she has read from Delaware or other states dealing with the internal affairs of noncorporate entities and nonpublic corporations. An open-ended question asking the attorney for any other sources by which he or she formed an impression as to the quality of the Delaware judiciary when it came to dealing with the internal affairs of LLCs rounded out this line of inquiry. The goal of this series of questions is to see the extent to which Delaware is trading on general reputation transferred unthinkingly from its prominence in the public corporate law context.

As the final question in the group triggered by the surveyed attorney's invocation of Delaware's judicial superiority, I asked whether the LLC agreements of the clients' Delaware LLCs contained a forum selection clause choosing Delaware courts for litigation under the contract. This question gave some insight on how far the attorney would go to ensure that any litigation involving the internal affairs of the clients' Delaware LLCs ended up in the Delaware courts, since, without such a provision, there is no rule that litigation involving the internal affairs of a Delaware LLC can only occur in Delaware.<sup>204</sup>

Finally, there were some wrap up questions asking whether the attorney had discussed the topic of state of formation of LLCs with other attorneys at his or her law firm or more broadly. If so, I asked

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<sup>203</sup> If, however, the attorney viewed Delaware's superiority solely in terms of having a larger number of relevant decisions—thereby providing the attorney more guidance—without regard to the quality of the decisions, then I did not ask the attorney the questions on the Delaware judiciary.

<sup>204</sup> *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-111 (West 2012) (actions to enforce or interpret LLC agreement “may” be brought in Delaware Chancery Court).

the attorney whether he or she would expect such attorneys to give similar answers—thereby trying by hearsay to broaden the reach of the survey—and, if he or she expected different answers, for referrals of attorneys with different views (thereby creating something of a “snowball sample”). The final question in the survey extended an open invitation for any other comments.

## *B. Results*

### *1. Basic Answers on State of Formation Choices*

The principal places of business for the LLCs covered by this survey span the United States. Specifically, while some of the surveyed attorneys reported that all of their clients’ LLCs had their principal places of business in the attorney’s home state—which, as discussed above,<sup>205</sup> covers twenty-three states in all regions of the country—most of the surveyed attorneys also reported forming LLCs to operate businesses outside the attorney’s home state.<sup>206</sup> As a result, the survey was sufficient to capture information on state of formation choices involving LLCs from most states.<sup>207</sup>

Figure 3 shows the choices for state of LLC formation reported by the surveyed attorneys.

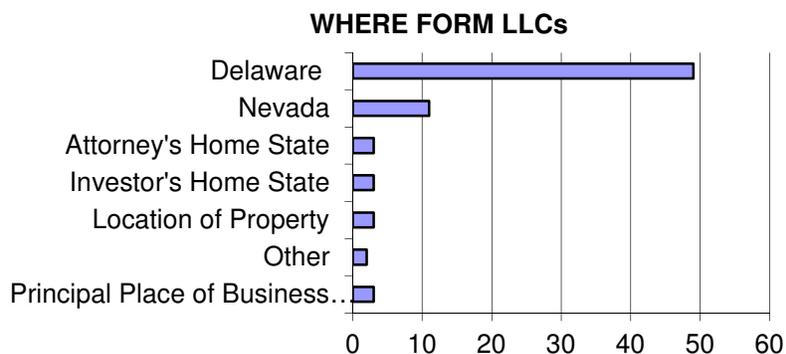
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<sup>205</sup> See *supra* text accompanying note 190.

<sup>206</sup> To be precise, of the forty-seven attorneys responding to the question, only ten reported exclusively aiding clients in forming LLCs whose principal place of business was in the attorney’s home state.

<sup>207</sup> Because ten of the attorneys reported that they aided forming LLCs with principal places of business “all over the United States” or, in a couple cases, all over either the “Eastern” or “Western” United States, it is difficult to be precise on this score. The states specifically listed by surveyed attorneys as the locations of the principal place of business for their clients’ LLCs include, in addition to the states shown on Figure 1 as the attorneys’ home states, the following: Alabama, Alaska, Florida, Iowa, Louisiana, Maryland, Massachusetts, Minnesota, Nevada, and Wyoming.

FIGURE 3.



Only three attorneys reported forming their clients' LLCs exclusively in the state of the LLC's principal place of business. As discussed above,<sup>208</sup> however, this low figure may be the result of selection bias. In fact, a number of the interviewed attorneys reported that other lawyers they knew were less likely to form LLCs outside the state of the company's principal place of business.<sup>209</sup>

Delaware was the overwhelming favorite when it came to selecting a state, other than the state of the LLC's principal place of business, in which to form the clients' LLCs. Forty-nine of the fifty attorneys who had some clients form LLCs in states other than that of the company's principal place of business reported Delaware as at least one of the states chosen for this role. Moreover, most of the surveyed attorneys who reported that some of their clients formed LLCs in states other than either Delaware or the state of the LLC's principal place of business reported that Delaware was the usual choice when it came to selecting a state in which to form the company other than the state of the LLC's principal place of business.<sup>210</sup>

Nevada was the next runner-up, with eleven attorneys reporting that sometimes their clients had formed Nevada LLCs for businesses

<sup>208</sup> See *supra* text accompanying note 190.

<sup>209</sup> I heard this comment from five attorneys. Two attorneys, however, expressed the view that they were less likely to push for Delaware formation than some other attorneys they knew.

<sup>210</sup> Specifically, fourteen of the surveyed attorneys, whose clients formed LLCs in states other than either the state of the company's principal place of business or Delaware, stated that Delaware was the usual choice when their clients formed LLCs in states other than the state of the company's principal place of business, while five attorneys listed both Delaware and Nevada without indicating that Delaware predominated over Nevada.

outside of Nevada.<sup>211</sup> On occasion, surveyed attorneys reported forming their clients' LLCs in states other than the state of the company's principal place of business when the state of formation was the attorney's home state,<sup>212</sup> the home state of an investor in the LLC,<sup>213</sup> the state within which the LLC held real estate,<sup>214</sup> or based upon some other rationale.<sup>215</sup>

As discussed earlier,<sup>216</sup> the survey asked whether any of four general factors—state of the principal place of business, size of the business, client's expected role in the LLC, and intent to bring in outside investors after formation—impacted the decision to form the clients' LLCs in a state other than the state of the LLC's principal place of business. Size of the business and intent to bring in outside investors after formation produced the most definitive answers. Specifically, a solid majority answered consistently with the D&S finding (and the normal intuition) that larger LLCs might form outside the state of the principal place of business (mainly in Delaware), while smaller (“mom and pop”) businesses formed LLCs in the state of their principal place of business.<sup>217</sup> A larger majority of the surveyed attorneys reported that the intent to raise money from outside investors after formation increased the chance of forming the LLC in a state other than the state of the company's principal place of business, especially in Delaware.<sup>218</sup>

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<sup>211</sup> In the last decade, amendments to Nevada's corporate law that insulate directors from liability to a greater extent than the law in Delaware have spawned an increase in Nevada incorporation. Michal Barzua, *Market Segmentation: The Rise of Nevada as a Liability-free Jurisdiction* (Univ. of Va. Sch. of Law Va. Law & Econ., Research Paper No. 2011-07, 2011), available at [ssrn.com/abstract=1920538](http://ssrn.com/abstract=1920538). Because Delaware was the far-more-frequent choice in forming LLCs—even in most cases for attorneys whose clients had also formed Nevada LLCs—the interviews never got into the reasons for clients choosing to form Nevada LLCs. Indeed, a couple of the surveyed attorneys volunteered that forming LLCs under Nevada law was their clients' idea and the attorneys did not favor the choice.

<sup>212</sup> Three attorneys reported this.

<sup>213</sup> Three attorneys reported this.

<sup>214</sup> Three attorneys reported this.

<sup>215</sup> Two attorneys reported this. For example, one East Coast attorney was impressed with the South Dakota statute. Go figure.

<sup>216</sup> See *supra* text in paragraph after note 196.

<sup>217</sup> Twenty-six of the surveyed attorneys reported this, while fifteen of the surveyed attorneys answered that size did not matter.

<sup>218</sup> Twenty-eight of the surveyed attorneys reported this, while six of the surveyed attorneys answered that this factor did not matter. (There were fewer responses in total to this question than to the question regarding the impact of size because a number of the surveyed attorneys had not represented clients in forming LLCs that planned to raise money from outside investors.)

Reactions to the two other general factors were more mixed. Some of the surveyed attorneys mentioned a number of states in which they would recommend their clients not form LLCs. These included New York (with six attorneys listing it as a state to stay away from<sup>219</sup>), California (also with six attorneys listing it as a state to stay away from<sup>220</sup>), Florida (with five attorneys listing it as a state to avoid<sup>221</sup>), Tennessee (with three attorneys condemning it<sup>222</sup>), and South Carolina (with two attorneys recommending avoiding it). Alabama, Connecticut, Mississippi, Missouri, Nevada, New Jersey, and Wisconsin each attracted a single attorney's disparagement; albeit one cannot draw too much of a conclusion from an isolated attorney's comment. During the course of their answers to other questions, the surveyed attorneys from some states (such as Illinois) seemed inclined to complain about their state's LLC law, while the surveyed attorneys from some states (such as North Carolina) seemed inclined to defend their state's LLC law and legal infrastructure. It is difficult to say how much of this reflected widely shared perceptions of the differences in the LLC laws and legal infrastructure in these states, and how much of this simply reflects different attitudes among attorneys regarding various features of LLC law and the degree of bias toward the attorney's home state.

Turning to the impact of the client's expected role on state of formation, I asked, as explained earlier,<sup>223</sup> whom the attorneys had represented when forming LLCs—in other words, had they ever represented clients expecting to be the sole owners, to be majority owners, to be managers, or to be minority investors (or was the client the LLC or someone else). The bulk (thirty-five out of forty-six) of the attorneys responding to this question reported that at various times their clients had fit all of these categories. When combined with those reporting narrower experience, all but two of the forty-six attorneys

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<sup>219</sup> With the exception of a complaint about New York's publication requirement—which entails extra fees—the attorneys did not give many specific grounds for their complaints about New York.

<sup>220</sup> As was the case with New York, the attorneys criticizing California typically were not very specific as to their reasons. Among the most specific was the comment that California's default rules were "not intuitive."

<sup>221</sup> One attorney characterized Florida's statute as "weird," while another complained about the state's LLC law regarding fiduciary duty and the remedies available to personal creditors of the members (beyond simply charging orders).

<sup>222</sup> Two attorneys characterized Tennessee's statute as "weird," and the attorneys disliked Tennessee's mandatory provisions and default provisions that were difficult to contract around.

<sup>223</sup> See *supra* text accompanying note 196.

responding to this question had experience representing all of the prospective owners of the LLC, and the same number had experience representing parties planning to own a majority of, but not all, interests in the company. A total of forty of the attorneys reported experience having represented clients expecting to manage the LLCs even if they did not own a majority. A total of thirty-seven of the surveyed attorneys reported that, at one time or another, they had represented clients who expected to be minority investors in the LLC, rather than representing clients expecting to be managers or majority owners, or representing all the owners (although many of these attorneys added that representing minority investors was the exception in their practice). This established the predicate for questions that sought to determine whether state of formation choices were different when the attorney represented those expecting to be managers and majority owners, versus when representing prospective minority investors.<sup>224</sup>

I asked every attorney who gave more than one answer to the question about the clients' expected role whether the client's expected role impacted the likelihood of the LLC being formed in a state other than the state in which the LLC had its principal place of business. The answers were fairly closely divided. Twenty-two attorneys reported that the expected role of the client at least sometimes made a difference, while eighteen stated that it did not. Two of the attorneys, who said that their representation of prospective minority investors did not impact the state of formation of the LLC, explained, however, that this was because the prospective managers or majority owners made the decision of where to form the LLC. Fourteen of the attorneys who stated that the client's expected role made a difference elaborated that they would prefer to form in Delaware if they represented majority owners or managers, and they would prefer their home state if they represented minority investors; albeit five attorneys

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<sup>224</sup> Representing all of the prospective members also could produce a different result in terms of state of formation from just representing managers or majority members. This, however, raises the delicate conflict-of-interest problem facing the attorney who represents both prospective minority and majority members in an LLC. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.7 & cmts. 8, 28 (2010) (discussing conflicts of interest in representing multiple parties in forming a business). By and large, the surveyed attorneys did not separately consider the impact of representing all members—except two who reported that this led to formation in the state of the principal place of business—and I did not press the issue.

saw it the other way (and three attorneys raised other impacts of the clients' expected role<sup>225</sup>).

## 2. *Overview of Expressed Reasons for Selecting Delaware*

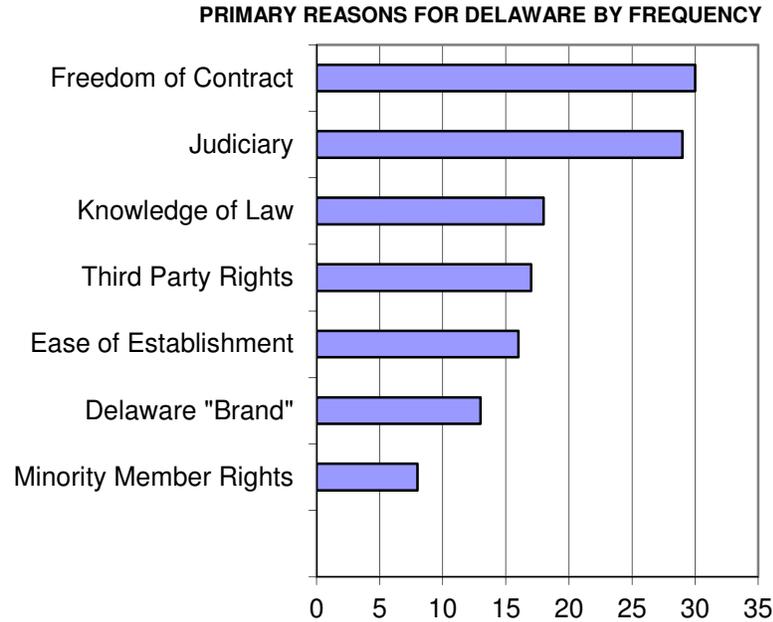
Figure 4 presents the primary reasons given by attorneys for selecting Delaware as the state of formation for LLCs.<sup>226</sup> Frequency is measured here in terms of how many attorneys invoked a factor. This does not necessarily mean that the factors invoked by more attorneys impacted more LLCs. It is always possible that a large fraction of the surveyed attorneys might invoke a factor that impacted only a few of their clients' LLCs—particularly if this factor was highly memorable rather than typical. On the other hand, the factors most often mentioned did not seem to have anything dramatic about them that would suggest the interviewees confused the memorable with the typical. (The danger in survey research of interviewees confusing what was memorable with what is more typical in their experience might have been a problem if dealing with transactions that were much less frequent and involved much more highly contextualized decisions than choice of state of formation for LLCs.)

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<sup>225</sup> For example, if they represented all of the expected members, then they would favor the state of the LLC's principal place of business.

<sup>226</sup> Not surprisingly, most attorneys listed more than one reason for establishing LLCs in Delaware, so the total number of responses in Figure 3 is greater than the number of surveyed attorneys whose clients established Delaware LLCs.

FIGURE 4.



The top two reasons for forming LLCs in Delaware were the freedom of contract (including the ability to waive fiduciary duties) established by Section 18-1101 of Delaware's LLC statute, and Delaware's judicial infrastructure. More than half of the forty-nine surveyed attorneys whose clients formed Delaware LLCs invoked one or both of these explanations, with thirty attorneys invoking freedom of contract among the reasons for establishing LLCs in Delaware and twenty-nine attorneys invoking the Delaware judiciary among the reasons for establishing LLCs in Delaware.

No other reason for choosing Delaware garnered mention by a majority of the surveyed attorneys whose clients formed Delaware LLCs. The next four most common reasons for clients forming their LLCs in Delaware were: the attorney's knowledge of Delaware LLC law (mentioned by eighteen attorneys), third party or creditor rights (mentioned by seventeen attorneys), the ease of establishing LLCs in Delaware (mentioned by sixteen attorneys), and the perceived prestige or brand value Delaware enjoyed (mentioned by thirteen attorneys). Each of these reasons received mention from between one-

third and one-quarter of the surveyed attorneys whose clients formed Delaware LLCs.

Fewer attorneys invoked other reasons for their clients forming LLCs in Delaware and the other reasons typically received little emphasis even from these attorneys. Eight attorneys mentioned the impact of the choice on minority member rights (other than through flexibility of contract and fiduciary duty waiver); albeit, as discussed later,<sup>227</sup> these comments often only came about in response to specific questions about Delaware's freeze-out merger provision. Five attorneys invoked the overall quality of Delaware's LLC statute, although an equal number criticized the same. Five attorneys mentioned several different possible tax advantages to forming under Delaware law.<sup>228</sup> Four attorneys listed unspecified company governance provisions of Delaware's LLC act as advantageous. Two attorneys mentioned Delaware's enforcement of oral LLC agreements<sup>229</sup> as a potentially positive (or negative) factor. Two attorneys invoked Delaware's allowance of flexible capital structures in LLCs.<sup>230</sup> Two attorneys stated that lenders had demanded Delaware formation. Two attorneys raised the enforceability of contractual penalties (for example, for failing to meet capital calls as required by the contract).<sup>231</sup> Two attorneys mentioned provisions in Delaware's statute allowing non-LLCs to convert to LLCs (and vice versa),<sup>232</sup> while another attorney mentioned the availability of mergers between LLCs and other types of business entities.<sup>233</sup> One attorney mentioned the permissibility of single-person LLCs in Delaware as a factor.<sup>234</sup> One attorney mentioned the enforceability under Delaware law of noncompetition provisions in the LLC agreement.<sup>235</sup> One attorney mentioned Delaware's allowing waiver of

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<sup>227</sup> See *infra* text accompanying notes 244 and 246–47.

<sup>228</sup> It was often unclear whether these tax advantages are perceived or real.

<sup>229</sup> DEL. CODE ANN. tit. 6, § 18-101(7) (West 2012).

<sup>230</sup> *Id.* §§ 18-503, -504. It is not clear that this differs, however, from other states' LLC acts.

<sup>231</sup> *Id.* §§ 18-306, -502(c).

<sup>232</sup> *Id.* § 18-214.

<sup>233</sup> *Id.* § 18-209(a), (b).

<sup>234</sup> *Id.* § 18-101(6).

<sup>235</sup> See *O'Leary v. Telecom Res. Serv., LLC*, No. 10C-03-108-JOH, 2011 WL 379300, at \*6 (Del. Super. Ct. Jan. 14, 2011), available at <http://www.courts.state.de.us/opinions/download.aspx?ID=150060> (holding that a non-compete clause barring plaintiff from rendering services to a competitive business anywhere in the United States for a period of four years is not invalid as a matter of law). Whether Delaware law is really that different from other states on non-competition agreements in the LLC context is not clear.

dissenter's rights.<sup>236</sup> One attorney pointed to the convenience (in terms of managing annual filings) of LLCs that were wholly owned subsidiaries of Delaware public corporations also formed under Delaware law.

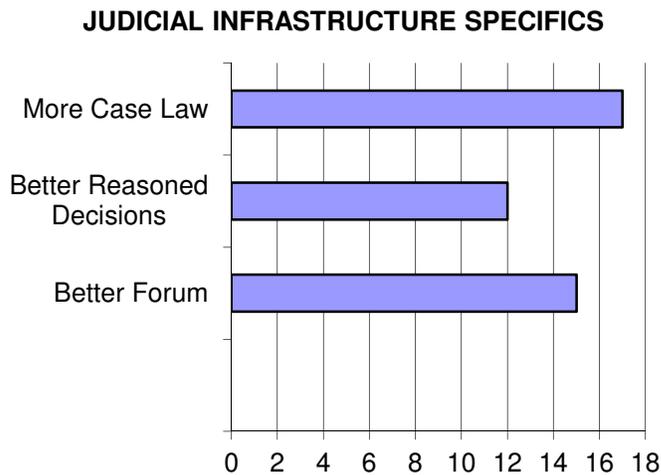
In sum, putting aside for the most part the more isolated rationales, the reasons for forming Delaware LLCs expressed by the surveyed attorneys fall into two broad camps. There are a variety of infrastructure advantages possessed by Delaware. There are also substantive rules of Delaware law that impact minority investors and creditors. The next two sections of this Article explore the attorneys' answers about these rationales in more detail.

### 3. *Legal and Other Infrastructure*

The survey results are generally consistent with the academic legal literature and some of the findings of the statistical correlation studies in suggesting the importance of legal infrastructure to Delaware's attractiveness as a state of formation for LLCs. These results, however, suggest that this is much more complicated than simple metrics of judicial quality or statutory typicality.

To begin with, as shown in Figure 5, the interviews established that the attorneys, who invoked the Delaware judiciary as at least one reason for their clients forming LLCs in Delaware, actually had in mind any of three distinct rationales.

FIGURE 5.



<sup>236</sup> Actually, appraisal rights only exist under the Delaware act if the agreement provides for them. DEL. CODE ANN. tit. 6, § 18-210 (West 2012).

One rationale, invoked by seventeen attorneys, corresponds to the original network rationale developed in the academic literature dealing with state of formation choices by public corporations.<sup>237</sup> Delaware simply has more court opinions on LLC law—even after two decades of the entity’s presence in Delaware—or at least has more court opinions relevant to LLC law when one also counts corporate law opinions likely, in the view of a number of surveyed attorneys, to apply by analogy. Hence, the attorney has a greater chance of finding an opinion by a Delaware court on a given issue, thereby establishing greater certainty for the attorney. A different rationale, invoked by twelve attorneys, is that Delaware court opinions are better reasoned—regardless of the quantity of opinions or whether the attorney agrees with or prefers the substantive result. In this instance, the advantage for the attorney is greater clarity and predictability in the law. Finally, a third rationale, invoked by fifteen attorneys, is that it would be preferable to have any litigation between the LLC’s members and managers occur in Delaware courts. This may be either because of the sophistication of Delaware judges in matters of business law or because of the efficiency with which Delaware courts dispatch business litigation.

A series of follow-up questions provides some insight into the sources of information used by the attorneys who invoked the rationales going to the qualitative superiority of the Delaware judiciary (rather than simply more case law). The dominant source appears to be, not surprisingly, reading opinions of Delaware courts relevant to LLC law. All of these attorneys, when asked, reported that they had read Delaware court opinions dealing with the internal affairs of LLCs or nonpublic corporations, and virtually all gave a positive evaluation of the Delaware court opinions they had read. Typical comments included “thoughtful,” “more sophisticated,” “more savvy,” “thorough and well analyzed,” and “don’t hear [from Delaware judges] ‘limited liability corporation’ [for limited liability company] or ‘shareholder’ [instead of member].” Of course, the state of formation decision is a comparative one, and so it is not surprising that the second-most common source of information appears to be reading the opinions of the attorney’s home state’s courts relevant to LLC law. Twelve of seventeen attorneys answered in the affirmative when asked if they had read opinions of non-Delaware courts—which the attorneys generally took as referring to courts in their home

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<sup>237</sup> See Klausner, *supra* note 15, at 842–47.

state—dealing with the internal affairs of LLCs or nonpublic corporations. The smaller number versus those who have read Delaware court opinions reflects the lack of reported opinions from courts in some of the attorneys' home states, which, in turn, supports the quantitative rationale (more relevant case law) for favoring the Delaware judiciary. The attorneys' evaluations of opinions from the courts of their home states relevant to LLC law were almost invariably inferior to their evaluations of Delaware court opinions. Typical comments were “not as good [as Delaware],” “uneven,” or “mixed.”

Few of the attorneys (only three) who invoked the qualitative superiority of the Delaware judiciary had, or knew an attorney who had, litigated cases in Delaware courts involving the internal affairs of LLCs or nonpublic corporations. This illustrates how indirect the sources are by which numerous attorneys came to believe that Delaware judges would actually be better in deciding cases involving LLCs. More (nine) of the surveyed attorneys who invoked the qualitative superiority of the Delaware judiciary had, or knew attorneys who had, litigated LLC or nonpublic corporation cases in their home states' courts. These attorneys generally were uncomplimentary in their evaluations from experiences litigating in their home states. Comments ranged from the sly “no comment” or “well intentioned,” to the blunt “crappy” or “slow and often wrong.”

Ten of the attorneys who invoked the qualitative superiority of the Delaware judiciary mentioned other sources of information they used in reaching this conclusion. Some of these included simply the existence of the Delaware Chancery Court and the greater experience with business cases this creates, or that their home state courts follow Delaware decisions. One of the more interesting sources, mentioned by five attorneys, to those in the legal academy is scholarship (articles and presentations) by Delaware judges—showing one practical utility to legal scholarship.<sup>238</sup>

Eleven of the fifteen surveyed attorneys who desired to have Delaware courts decide litigation involving the internal affairs of their clients' LLCs included forum selection clauses in the LLC agreements.

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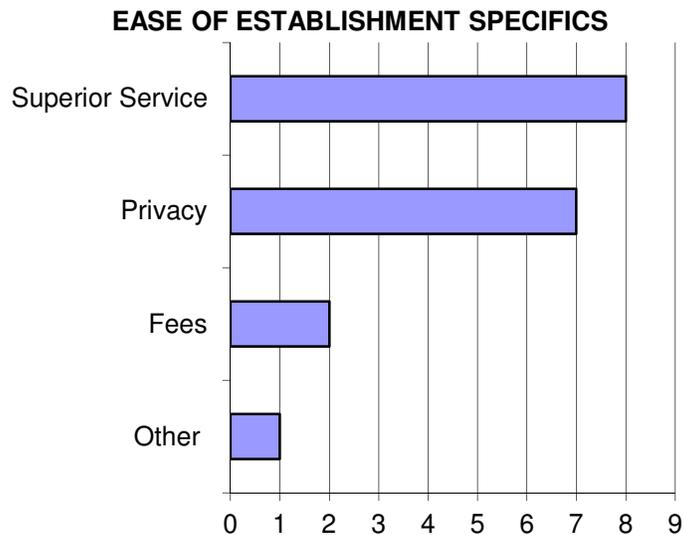
<sup>238</sup> This supports a thesis by Steven Cleveland as to why Delaware judges engage in scholarship. Steven J. Cleveland, *Process Innovation in the Production of Corporate Law*, 41 U.C. DAVIS L. REV. 1829, 1842 (2008).

Delaware's infrastructure advantage in the minds of many of the surveyed attorneys goes beyond its judiciary. The attorney's knowledge of Delaware law, the ease of establishment in Delaware, and Delaware's reputational cache were among the next tier of commonly invoked rationales for forming LLCs in Delaware.

Eighteen of the surveyed attorneys invoked their knowledge of Delaware law as a major reason for forming LLCs in Delaware when the principals in the LLC were from different states. A typical pattern might involve an LLC with three members—one from State A, one from State B, and one from State C—each represented by an attorney from the member's home state. Each member's attorney is familiar with the law in his or her own state, but unfamiliar with the law in the other members' home states. Each attorney is hesitant to form the LLC under the law of a state with which he or she is not intimately familiar, lest there be some unknown rule that will disadvantage his or her client. Because all three attorneys are also familiar, however, with Delaware LLC law, the parties agree on forming in Delaware as "neutral ground."

As shown in Figure 6, the sixteen surveyed attorneys who invoked ease of establishment as a reason for forming LLCs in Delaware actually represent a conglomeration of attorneys who raised several more specific reasons.

FIGURE 6.



The most common reason, invoked by eight of these attorneys, was the superior service provided by the Delaware Secretary of State's office. This office could establish the LLC the day after filing for an extra \$100, the same day for an extra \$200, or even in an hour for an extra \$1000 charge.<sup>239</sup> By contrast, the California Secretary of State is so understaffed that a couple of the interviewees had experienced a multi-week delay between filing and the actual formation of a California LLC. Seven attorneys pointed to the fact that Delaware did not require disclosure of the names of the LLC's members, thereby providing more privacy for LLC members.<sup>240</sup> A couple of attorneys mentioned lower fees in Delaware,<sup>241</sup> while one attorney mentioned private infrastructure (corporate service firms and the like).

Thirteen of the surveyed attorneys invoked yet a different sort of infrastructure advantage possessed by Delaware. This was the "prestige" or "brand" value associated with being a Delaware LLC. The surveyed attorneys did not associate this with any particular feature of Delaware's law or legal infrastructure, but rather they viewed this just as a general reputational cache associated with formation in Delaware. This was particularly important in the context of LLCs seeking investors from outside the state of the LLC's principal place of business, who, to repeat the expression used by one surveyed attorney, would view formation in the state of the LLC's principal place of business as "rinky dink."

Five attorneys mentioned advantages of the overall Delaware LLC statute among the reasons for their clients forming Delaware LLCs. Specifically, four pointed to the statute being kept up to date, while one mentioned fewer political provisions.<sup>242</sup> Interestingly, an equal number of attorneys criticized the general quality of the Delaware statute, finding it poorly written.

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<sup>239</sup> DELAWARE DEPARTMENT OF STATE, DIVISION OF CORPORATIONS FEE SCHEDULE (2009), available at <http://corp.delaware.gov/Aug09feesch.pdf>.

<sup>240</sup> To deal with states that require disclosure of members of foreign LLCs registering to do business in the state, one attorney explained that his clients formed Delaware LLCs to act as members of the LLCs that would have their principal place of business in those states.

<sup>241</sup> This seems to ignore, however, the prospect of a high-fee state, such as California, charging Delaware LLCs the same high fees when the Delaware LLCs must, because they have their principal place of business within the high-fee state, qualify to do business in the high-fee state.

<sup>242</sup> This attorney contrasted Delaware with his state, in which the legislature enacted or threatened to enact provisions in the LLC statute in order to deal with "hot button" political issues—for example, cancelling the charter of any LLC found to be employing undocumented workers.

#### 4. *Creditor and Minority Investor Protections*

##### a. *Minority Member Protections*

As predicted in the race to the bottom debate, a number of rationales given by the surveyed attorneys for their clients forming Delaware LLCs involve creditor and minority investor protections. The far most common of these rationales was the freedom of contract and the ability to waive fiduciary duties provided by Section 18-1101 of Delaware's LLC statute. A total of thirty attorneys mentioned this.

Having a question on the survey specifically ask about Section 18-1101 introduces the potential for biasing the responses. In response to the question of whether Section 18-1101 impacted the choice to form Delaware LLCs, thirty attorneys replied in the affirmative (or had already said this), while fifteen attorneys replied in the negative. (One attorney who replied in the affirmative said it was a factor, but worked differently from everyone else's because his home state's law allowed broader waivers. One other attorney was uncertain.) Still, twenty-three of the thirty attorneys who invoked this reason for clients forming LLCs in Delaware did so prior to being asked the specific question about Section 18-1101. Moreover, only six attorneys gave an affirmative reply when asked if Section 18-209 (the merger provision) impacted the choice to form LLCs in Delaware, with thirty-six replying in the negative—suggesting that merely asking about a particular section does not trigger a large number of affirmative responses.

Interestingly, of the fifteen attorneys who stated that Section 18-1101 did not impact the choice of whether to form their clients' LLCs in Delaware, eight explained that this was because the state of the LLCs' principal place of business had essentially the same provision in its LLC statute.

The fact that Delaware seems to be attracting formation of LLCs by a statutory provision favoring freedom of contract and allowing waiver of fiduciary duties suggests a "race to laxity" or flexibility, but not necessarily a "race to the bottom." It could be, as a number of the surveyed attorneys asserted, that such waivers and any other contractual terms allowed by Section 18-1101 represent the desired outcomes for sophisticated parties forming LLCs. Here is where the questions regarding the impact of the client's expected role in the LLC come into play. Specifically, if fiduciary duty waivers or other terms allowed by virtue of Section 18-1101's freedom of contract are mutually beneficial, then the desire to form Delaware LLCs because

of Section 18-1101 presumably should not depend upon the expected role of the client—specifically, whether the client expected to be a manager or majority owner, versus a minority investor. Yet, of the thirty attorneys who stated that Section 18-1101 impacted the decision to form LLCs in Delaware, seventeen attorneys responded in the affirmative when asked if this depended upon the client's expected role, while only seven attorneys stated it did not matter.<sup>243</sup>

Section 18-1101 had a mixed impact on the agreements governing the clients' Delaware LLCs. Thirty attorneys reported that the LLC agreements governing their clients' Delaware LLCs contained provisions waiving some or all fiduciary duties, while twelve attorneys reported that the agreements did not contain such provisions. This, of course, does not establish that the agreements would have been different if the clients did not form their LLCs in Delaware. With respect to that question, nineteen attorneys reported that, because of Section 18-1101, the agreements governing their clients' Delaware LLCs had different provisions than the agreements governing their clients' non-Delaware LLCs. This generally meant more complete waivers than the LLC agreements for the non-Delaware LLCs; as one attorney put it, Section 18-1101 encouraged agreements to “push the envelope.” On the other hand, twenty-one attorneys reported that there was no difference in the language of their clients' LLC agreements because of Section 18-1101.<sup>244</sup> Three of these attorneys explained that this was because the LLC statute of the principal place of business of their clients' LLCs has a provision equivalent to Section 18-1101. Two other attorneys reported that, while the agreements' language did not change because of Section 18-1101, the impact of the agreement could be different. This was because the agreements contained provisions waiving fiduciary duties “to the extent allowed by law.” Three attorneys reported that, while the agreements for their clients' Delaware and non-Delaware LLCs used the same waiver language, the attorney did so recognizing that the waiver might not be valid for the non-Delaware LLCs.

Relatively few of the surveyed attorneys (only six) responded in the affirmative when asked if Section 18-209 (allowing the majority to freeze out the minority or to amend the LLC agreement through a merger) impacted the decision to form their clients' LLCs in

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<sup>243</sup> Five stated that they only represented clients expecting to be managers or majority owners, and one attorney was uncertain.

<sup>244</sup> Two attorneys were uncertain.

Delaware.<sup>245</sup> Even then, the salience of this factor could not have been large, as no attorney raised this as a reason for forming LLCs in Delaware before the specific question about the section. Of those who responded in the affirmative when asked if this Section impacted the choice to form their clients' LLCs in Delaware, three also responded in the affirmative when asked if this depended upon the client's expected role in the LLC, while only one responded that it did not.<sup>246</sup>

Of the thirty-six attorneys who viewed Section 18-209 as unimportant to the choice of state of formation, many volunteered the explanation that this was because they could simply contract around it. Interestingly, however, a number of the attorneys' answers about provisions in their clients' LLC agreements raised doubts as to whether the LLC agreements had, in fact, always contracted around the difference between Delaware and non-Delaware law created by Section 18-209. It is difficult to be too specific here, because I did not examine the LLC agreements, and it turned out to be challenging to do justice to this subject in an interview. This said, my best interpretation of the answers—and generally giving the benefit of the doubt to the attorneys who claimed to have eliminated the impact of Section 18-209 by contract—is that Section 18-209 seems to have produced different rights in the clients' Delaware LLCs versus non-Delaware LLCs for eleven of the surveyed attorneys, while seventeen attorneys seem (giving them the benefit of the doubt in many instances) to have achieved parity between Delaware and non-Delaware LLCs despite Section 18-209. (In other cases, the answers were insufficient even to guess.) In the cases in which attorneys appeared to have achieved parity—and the parity did not vary with every deal—it appears that slightly more attorneys (eight) had their clients' Delaware LLCs contract around Section 18-209 than had their clients' non-Delaware LLCs contract for the equivalent of Section 18-209 (six).

A few of the surveyed attorneys raised a couple of other rationales dealing with minority member rights for forming their clients' LLCs in Delaware. A couple of attorneys stated that minority members had less right to information from the LLC under Delaware law.<sup>247</sup> A

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<sup>245</sup> In one instance, this involved moving an existing LLC's state of formation from the state of its principal place of business to Delaware precisely in order to take advantage of Section 18-209.

<sup>246</sup> The remaining two did not provide answers.

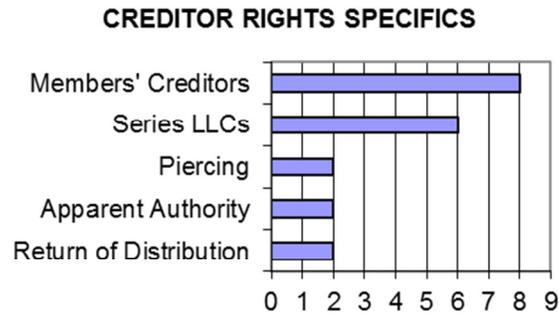
<sup>247</sup> See DEL. CODE ANN. tit. 6, § 18-305(g) (2012) (allowing LLC agreement to restrict rights to information).

couple of attorneys stated that minority members had less ability to pursue an action for oppression under Delaware law.<sup>248</sup>

*b. Creditor Protections*

Seventeen attorneys included rules limiting the protection of creditors among the reasons the attorneys gave for their clients forming LLCs in Delaware. While the common theme was to favor the interests of members over creditors, different attorneys found different rules dealing with creditor rights, as shown in Figure 7, important to this choice.

FIGURE 7.



Eight attorneys pointed to the limitations established by Delaware's statute on the rights of creditors of members (as well as the rights of other transferees of membership interests) as a reason for forming LLCs in Delaware. Specifically, Delaware's statute gives creditors of members only the ability to seek a charging order, which simply allows the creditor to obtain distributions from the company when and if the company makes such distributions.<sup>249</sup> This is advantageous to the remaining owners, who need not worry that a member's creditor might obtain the management or other rights that a shareholder's creditor could obtain in a corporation by seizing the stock of the debtor-shareholder. It is worth noting, however, that this limitation on rights of the members' personal creditors might also protect the interest of the LLC's creditors. While the LLC statutes of

<sup>248</sup> See *id.* § 18-802 (providing judicial dissolution "whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement," but not providing dissolution for oppression).

<sup>249</sup> *Id.* § 18-703.

states other than Delaware also limit the rights of the members' creditors and of transferees of membership interests,<sup>250</sup> a number of the surveyed attorneys stated that Delaware has some specific advantages in this area. For example, Delaware's LLC act expressly overrides UCC provisions that might otherwise trump restrictions on transfer of security interests in property, including a member's interest in an LLC, and thereby arguably allow a member's secured creditors to claim rights beyond a charging order.<sup>251</sup> Two of the surveyed attorneys mentioned Delaware's approval for what they labeled "springing" members—in other words, members who will not make a contribution to, and will not have any economic interest in, the LLC<sup>252</sup>—as an advantage of Delaware LLCs. As mentioned earlier,<sup>253</sup> this closes the possible gap in the protection against claims by the members' personal creditors, which arises if the personal creditors could obtain all the economic interests in the LLC and seek to dissolve the company.

Six attorneys invoked the availability of series LLCs as a reason for forming LLCs in Delaware. As discussed earlier,<sup>254</sup> the utility of the series LLCs (such as it is) involves arguably decreasing the prospects for piercing the veil of limited liability between commonly owned LLCs, and, hence, is a device to limit protection of creditors.

Two attorneys mentioned lesser prospects more generally for piercing the veil of limited liability under Delaware law. Since Delaware does not have a provision stating that the failure to follow meeting formalities will not lead to piercing (which is what D&S tested), the rationale of these attorneys is obviously different than that tested by D&S. One attorney pointed to California's statute, which provides that LLC owners will face the same danger of piercing as shareholders—except that failure to follow meeting formalities will not lead to piercing unless the LLC agreement calls for meetings.<sup>255</sup> This attorney's concern was not the negative pregnant in the caveat about LLC agreements that require meetings, but more generally the view that, by even raising the piercing issue, the California statute

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<sup>250</sup> *E.g.*, *I RIBSTEIN & KEATINGE*, *supra* note 120, § 7:8.

<sup>251</sup> DEL. CODE ANN. tit. 6, § 18-1101(g). *See also id.* § 18-103(c) (excluding interests in limited liability companies from the definition of "security" for purposes of Article 8 of the UCC with certain limited exceptions).

<sup>252</sup> DEL. CODE ANN. tit. 6, § 18-301(d).

<sup>253</sup> *See supra* note 173 and accompanying text.

<sup>254</sup> *See supra* notes 177–82 and accompanying text.

<sup>255</sup> CAL. CORP. CODE § 17101(b) (West 2011).

will encourage it in LLCs. The other attorney simply felt that Delaware courts would be less inclined to pierce.

Two attorneys were worried that members in an LLC in their home state would have more apparent authority to bind the firm to contracts with third parties than they would have in Delaware.<sup>256</sup> Two attorneys felt there was less potential under Delaware law that members would need to return distributions received from LLCs that later could not pay their creditors.<sup>257</sup>

#### IV

##### IMPLICATIONS AND AN AGENDA FOR FURTHER STUDY

This survey of attorneys suggests that two factors largely account for Delaware's attractiveness as a state in which to form LLCs: (1) legal and other infrastructure advantages; and (2) appealing to those who plan to be managers or majority owners of the LLCs. This much is consistent with theory and some of the results of the existing correlation studies. Yet, the attorney survey reveals a more complete story regarding these two factors than previously available.

To begin with, this survey enables us to reach a more robust understanding as to the nature and scope of Delaware's infrastructure advantage than provided just by the correlation studies or the theoretical legal literature. On the simplest, but nevertheless a highly significant, level, the survey results support Kobayashi and Ribstein and undercut Dammann and Schündeln with respect to the role of judicial infrastructure in choice of state of formation for LLCs. Indeed, the survey results provide direct evidence to support the inference of causation, which otherwise was only a tentative conclusion from the correlation found between LLC state of formation statistics and the various metrics of judicial quality tested by K&R. The survey results also seem to undercut the argument that the ability of parties in an LLC to provide detailed and tailored rules through the LLC agreement undermines the advantage Delaware

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<sup>256</sup> The basis for the belief that members of an LLC have less apparent authority under Delaware law is not entirely clear. *See* Jack J. Morris Assocs. v. Mispillion St. Partners, LLC, No. 07C-04-023-RFS, 2008 WL 3906755, at \*4 (Del. Super. Ct. Aug. 26, 2008), available at <http://www.courts.state.de.us/opinions/download.aspx?ID=110540> (denying summary judgment because there was a factual dispute concerning whether a member, and former manager, of an LLC had the apparent authority to bind the LLC to contracts).

<sup>257</sup> *See* DEL. CODE ANN. tit. 6, § 18-607(b) (members liable only if they knew distribution was impermissible).

obtains from its judicial infrastructure.<sup>258</sup> This is probably because attorneys recognize that the difficulty of drafting unambiguous and prescient contracts to govern long-term relationships, as in LLCs, leaves their clients dependent on judicial expertise—albeit these results do not show that Delaware could charge the same premium for this infrastructure advantage that it is able to do in the public corporate context.<sup>259</sup>

In addition, the survey results give us a more precise picture of what features of Delaware's judicial infrastructure motivate LLC state of formation decisions. As revealed in the survey, some attorneys are looking simply at the quantity of relevant case law in Delaware versus in other states—a result consistent with the original judicial infrastructure thesis in the corporate context and one of the metrics tested by K&R. Other attorneys focus, alternatively or additionally, on the quality of relevant judicial decisions in Delaware versus other states—a metric only obliquely tested by K&R's use of a judicial citation study. Still other attorneys focus, alternatively or additionally, on the desirability of actually litigating cases in the Delaware court system—a metric consistent with some of the academic literature,<sup>260</sup> but not tested particularly by either correlation study. No attorney seems interested in punitive damages or the productivity of judges—the two other metrics tested in the correlation studies.

While the survey results cannot dispel the suspicion that Delaware is, at least to some extent, trading on the reputation its courts had already gained in the public corporation context, the survey results demonstrate the importance of craftsmanship in writing court opinions, as well as the utility of presentations and articles by judges, in gaining a reputation for Delaware in the LLC context.

Delaware's legal infrastructure advantage, as expounded in the survey results, extends beyond its judiciary, suggesting that K&R and D&S were too narrow in the variables they tested. One significant policy implication of this is to douse the dreams of those who urge other states to create specialized business courts in order to compete

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<sup>258</sup> Manesh, *supra* note 55, at 234–35.

<sup>259</sup> *E.g.*, Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1217–27 (2001) (discussing Delaware's market power to charge high fees for public corporations).

<sup>260</sup> *See, e.g.*, Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 589–90 (1990).

with Delaware.<sup>261</sup> Some of the infrastructure advantages mentioned by the surveyed attorneys—particularly the efficient handling of LLC filings and the absence of a requirement to disclose publicly the names of members—would seem relatively easy for other states to duplicate if states had the will and committed the resources. Two other infrastructure advantages often mentioned by the surveyed attorneys—their knowledge of Delaware LLC law and the reputational value of forming in Delaware—would not be easy for other states to duplicate.

The common role that attorneys' knowledge of Delaware law plays in the selection of Delaware as a state of formation for LLCs is consistent with other empirical research. Specifically, it is similar to the results of a survey of attorneys involved in initial public offerings or IPOs, which suggests that attorneys' knowledge of Delaware law plays a critical role in choosing Delaware as the state of incorporation for companies going public.<sup>262</sup> Delaware's advantage in providing a commonly known law for LLCs formed by parties from different states illustrates the utility of uniform business organization acts, but also illustrates that a single state's law can provide the same utility. An interesting question beyond the scope of this survey would be to explore how legal and business culture comes to accept a particular state's law as the one beyond their home states' that most attorneys learn. By way of example, consider the decision of those who put together nationally published materials for law school Business Associations courses to use Delaware's act as the exemplar of an LLC statute.<sup>263</sup> Did this help create (at least in some small part), or did this simply reflect, cultural acceptance?<sup>264</sup>

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<sup>261</sup> See, e.g., Cleveland, *supra* note 239, at 1837 (some states are creating business courts in order to attract incorporation business); Ad Hoc Comm. on Bus. Courts, *Business Courts: Towards a More Efficient Judiciary*, 52 BUS. LAW. 947 (1997) (advocating for business courts).

<sup>262</sup> William J. Carney et al., *Lawyers, Ignorance, and the Dominance of Delaware Corporate Law* 27 (Emory Univ. Sch. of Law Pub. Law & Legal Research Paper Series, Research Paper No. 11-171), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1949261](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1949261).

<sup>263</sup> See, e.g., CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: STATUTES, RULES, MATERIAL, AND FORMS 338 (Melvin Aron Eisenberg ed., 2010); JEFFREY D. BAUMAN, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS STATUTES, RULES AND FORMS 1121 (2010).

<sup>264</sup> See Carney et al., *supra* note 262, at 8 (suggesting that IPO attorneys' knowledge of Delaware law, which leads to incorporation in Delaware, is because law school corporate law classes only teach the corporate law of Delaware and perhaps the school's home state).

The survey answers explain why the K&R study found no statistically significant results for the various measures of statutory typicality. True, a couple attorneys complained of statutes which contained provisions they characterized as “weird,”<sup>265</sup> but such comments were not widespread. Nor were there enough negative comments about those states which have adopted the Uniform Limited Liability Company Act to support D&S’s negative correlation based upon that variable.<sup>266</sup> In any event, given the pervasive knowledge of Delaware’s law, Delaware does not need to limit its law to provisions typical of other states in order for attorneys to be comfortable with its law.

The surveyed attorneys’ mention of Delaware’s reputational cache, particularly with investors, has potential policy implications beyond simply dousing the hopes of states that might wish to compete with Delaware. Those who believe in the wisdom of markets and the merits of brands as a communication of quality—rather than simply an exploitation of human irrationality—may argue that this reputation shows Delaware’s optimal balancing of managerial, majority, and minority investor interests. This is a nice segue into the other primary set of reasons for forming Delaware LLCs.

The surveyed attorneys’ frequent mention of Delaware’s freedom of contract and fiduciary duty waiver provisions create a quandary when contrasted with the failure of the K&R study to obtain a statistically significant correlation between fiduciary duty waiver provisions and LLC state of formation choices. It is possible, of course, that the attorneys in my survey sample were somehow idiosyncratic in their views when it came to this factor. On the other hand, this was such a consistent and frequent response that it is difficult to imagine that the mention of Section 18-1101 would have dropped off dramatically if I continued to interview more attorneys. As discussed above,<sup>267</sup> K&R’s failure to obtain statistically significant correlations with fiduciary duty waiver provisions might stem from difficulties in selecting the precise variable for testing. So, for example, K&R could have undercut correlation by dividing

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<sup>265</sup> See *supra* note 221.

<sup>266</sup> See *supra* notes 219–21 and accompanying text (listing states criticized by the surveyed attorneys). Among the states attracting criticism from more than one of the surveyed attorneys, only South Carolina (which two attorneys listed as a state to avoid) has adopted the Uniform LLC Act, and among the states attracting criticism from a single surveyed attorney, only Alabama has adopted the Uniform Act. See *supra* note 50.

<sup>267</sup> See *supra* notes 169, 183 and accompanying text.

waiver provisions with slightly different language inconsistently with the views of attorneys advising clients on where to form LLCs and by failing to consider the possible impact of court opinions interpreting and applying the waiver provisions. Given these problems and the survey results, one should view with skepticism K&R's conclusion that Delaware's freedom of contract provision does not drive LLC formation in Delaware. Instead, the discrepancy between the survey results and the K&R study strongly supports the need to study further the impact of Section 18-1101 on the choice to form Delaware LLCs before drawing any conclusions.<sup>268</sup>

The acknowledgement by a substantial fraction of the surveyed attorneys that their view of the desirability of Section 18-1101 depends upon whether they represent prospective managers and majority members or represent minority investors might give pause before assuming that terms allowed by Section 18-1101 represent the optimal balance of competing interests, as opposed to terms favored by those choosing the state of formation and drafting the LLC agreement.

Not surprisingly, the highly majority-favoring default rule provided by Delaware's merger provision (which allows the majority to kick out the minority or amend the LLC contract) registered as a potentially motivating, but only a very minor motivating, factor in the reasons given by the surveyed attorneys for forming LLCs in Delaware—essentially only showing up in the minority of affirmative responses to the specific question about the provision's impact. More interesting were the numerous responses by surveyed attorneys who proclaimed complete confidence in their ability to contract around either this default rule, or its absence, to obtain the members' desired arrangement. An interesting follow-up study would be to review LLC agreements to see the degree to which such agreements actually achieve this goal.

All told, the survey results contradict the notion that there is a flight from laxity when it comes to managerial liability or minority investor protection. Not only do the surveyed attorneys' answers dealing with freedom of contract and mergers show no flight from laxity, the only mention by the surveyed attorneys of the remaining variables relied on by D&S as showing a flight from laxity—as, for example, dealing with the oppression remedy—contradict the

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<sup>268</sup> This inquiry is sufficiently narrow to suggest the possibility of a written survey of a statistically significant sample of attorneys.

conclusion that parties organize LLCs in Delaware for greater managerial accountability or minority protections.

Finally, the mention by a number of the surveyed attorneys of provisions which disfavor creditor interests as a reason for forming LLCs in Delaware is consistent with the thesis that choice of state of formation tends to disfavor the interests of those who do not select in which state to form the company. The specific reasons invoked by the surveyed attorneys, however, had nothing to do with statutory provisions dealing with piercing and failure to follow meeting formalities. This suggests that D&S's 2010 finding of correlation between such provisions and state of formation choices is coincidental. In any event, the mention—albeit only by a couple of the surveyed attorneys—that the attorneys' clients had formed LLCs in Delaware at the insistence of creditors provides some countervailing data to the notion that Delaware sacrifices creditor interests. It might be more accurate to say that Delaware sacrifices the interests of creditors of the members, sometimes to the advantage of creditors of the company.

#### CONCLUSION

All told, the insights provided by this survey suggest that, while the statistical analysis generated by correlation studies is impressive, it never hurts to supplement raw numbers by actually talking to those involved with the decisions. This is not to say that survey results should be privileged over statistical studies. Rather, these are complementary methodologies that should be combined through an iterative dialogue. The next stage in this dialogue beckons to those interested.

## APPENDIX

## SURVEY QUESTIONS

**I. Introductory Remarks**

I am Franklin A. Gevurtz, Distinguished Professor and Scholar at the University of the Pacific, McGeorge School of Law.

I am conducting a survey to gather information on why Limited Liability Companies (LLCs) choose to form in (i.e. organize under the laws of) the states that they do. The subjects of this survey are business attorneys whose clients organized LLCs and therefore are in a position to explain in what state those LLCs were formed and why.

Your answers will be kept completely confidential and the results of this project will be reported in a way to assure anonymity. This survey is entirely voluntary and you are free to decline to answer any question. It should take around 15 minutes to complete the survey.

**II. Questions Regarding Respondent's Experience With LLCs**

1. Have you advised clients in forming LLCs?
2. What were your clients' expected roles in these LLCs—in other words, did your clients expect to:
  - a) be the only members in the LLC
  - b) own a majority of membership voting interests in and manage the LLC, but not be the only members
  - c) be managing members or managers, but not own a majority of membership voting interests
  - d) be minority members
  - e) be the LLC itself
  - f) other (explain)

[Please state all that apply; but also please state which, if any, has predominated in your practice.]

3. Did these LLCs plan to raise money by later selling ownership interests to persons not involved in their formation?

**III. Basic Questions Regarding Choice Of State Of Formation**

1. In what state(s) did your clients' LLCs have their principal place(s) of business?
2. Were these LLCs formed in a state (in other words, established as a legal entity under the laws of a state) other than the state

of their principal place of business? If so, in what state were they formed?

3. For LLCs formed in a state other than their principal place of business, what were the reasons for selecting the particular state picked as the state of formation?
4. *To be asked of attorneys who listed more than one state in answer to Question III.1:* In your experience, were LLCs more likely to be formed in a state other than their principal place of business if their principal place of business was in certain states? If so, for which states was this true and why? Were the LLCs less likely to be formed in a state other than their principal place of business if their principal place of business was in certain states? If so, for which states was this true and why?
5. In your experience, were LLCs of a certain size business more likely to be formed in a different state than their principal place of business? If so, please explain.
6. *To be asked of attorneys who checked more than one answer in response to Question II.2:* In your experience, did the likelihood of the LLCs being formed in a different state than their principal place of business vary depending upon your clients' expected role in the LLC? If so, please explain.
7. *To be asked of attorneys who answered yes to Question II.3:* In your experience, were LLCs more likely to be formed in a different state than their principal place of business if the LLCs planned to raise money by later selling ownership interests to persons not involved in their formation?

#### **IV. Questions Regarding Impact Of Statutory Provisions**

1. Were there any particular provisions in a state's statute governing LLCs that made it more likely that your clients' LLC would be formed in this state?
2. Were there any particular provisions in a state's statute governing LLCs that made it less likely that your clients' LLC would be formed in this state?
3. Section 18-1101 of Delaware's Limited Liability Company Act provides that the "policy of [the Act is] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements" and allows elimination of all fiduciary and other duties, except for the duty of good faith and fair dealing.

- a) Has this section impacted the likelihood of your clients' LLC being formed in Delaware? If so, how?
  - b) Did the answer to the question above depend upon what role your client expected to have in the newly formed LLC? If so, how?
  - c) Do the LLC agreements for any of your clients' LLCs formed in Delaware contain any different provisions or language than the agreements would have contained in the absence of Section 18-1101? If so, what do these provisions or such language say?
  - d) Do the LLC agreements for any of your clients' LLCs formed in Delaware contain any provisions eliminating, waiving or otherwise limiting fiduciary duties of managers or members? If so, what do these provisions say? Are identical provisions found in the LLC agreements of your clients' LLCs formed in states other than Delaware?
4. Section 18-209 of Delaware's Limited Liability Company Act allows, in the absence of explicitly contrary provision in the LLC agreement, the majority in ownership to amend the LLC agreement, or to remove the minority, through a merger with a shell entity.
- a) Has this section impacted the likelihood of your clients' LLC being formed in Delaware? If so, how?
  - b) Did the answer to the question above depend upon what role your client expected to have in the newly formed LLC? If so, how?
  - c) Have the LLC agreements for any of your clients' LLCs formed in Delaware contained any different provisions or language than the agreements would have contained in the absence of Section 18-209? If so, what do these provisions or such language say?
  - d) Do the LLC agreements for your clients' LLCs formed in Delaware typically contain provisions expressly limiting the ability of the majority to amend the LLC agreement or remove the minority pursuant to a merger under Section 18-209?
  - e) Do the LLC agreements for your clients' LLCs formed in states other than Delaware typically contain provisions allowing the majority to amend the LLC agreement or

remove the minority, whether pursuant to a merger or otherwise?

## V. Questions Regarding Impact Of Judiciary

*To be asked of attorneys whose answer to Question III.3 involves the quality of the Delaware judiciary:*

1. Have you or any attorneys you know represented parties in litigation in Delaware courts involving the internal affairs of noncorporate entities or non-publicly held corporations? If so, what was your impression of the quality of decisions in those cases? Can you give examples?
2. Have you or any attorneys you know represented parties in litigation in courts outside Delaware involving the internal affairs of noncorporate entities or non-publicly held corporations? If so, what was your impression of the quality of decisions in those cases? Can you give examples?
3. Have you read opinions of Delaware courts involving the internal affairs of noncorporate entities or non-publicly held corporations? If so, what was your impression of the quality of those decisions? Can you give examples of opinions that established this impression?
4. Have you read opinions of courts outside of Delaware involving the internal affairs of noncorporate entities or non-publicly held corporations? If so, what was your impression of the quality of those decisions? Can you give examples of opinions that established this impression?
5. Is there anything else upon which you have based your impression of the quality of the Delaware judiciary when it comes to issues involving the internal affairs of LLCs? Please explain.
6. Do the LLC agreements of Delaware LLCs your clients formed contain a provision selecting Delaware courts as the forum for litigation between members?

## VI. Concluding Questions

1. Have you discussed the subject of state of formation for LLCs with other business attorneys at your firm, or have otherwise become aware of what their clients forming LLCs do with respect to this issue? If so, would you expect that I would receive similar answers to the questions in this survey if I interviewed other business attorneys at your firm? Is there

anyone at your firm you could refer to me who would provide different answers?

2. Have you discussed the subject of state of formation for LLCs with business attorneys at others firms, or have otherwise become aware of what their clients forming LLCs do with respect to this issue? If so, would you expect that their clients' decisions regarding where to form LLCs and the reasons therefore would be similar to the answers you provided to the questions in this survey? Do you have any recommendations for business attorneys at other firms who I might interview for this survey?
3. Is there anything else that you would like to add that you think might be relevant to the issue explored by this survey?

