OWNERSHIP PIERCING

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ABSTRACT

In corporate law, there is an illusion of separateness. However, that idea cannot be further from the truth. In this article, I develop the concept of "ownership piercing." I use the expression to suggest that courts engage in a process of evaluative reasoning to clarify who owns property rights and controls the limited liability company. I show under what circumstances courts should pierce ownership. Ownership piercing entails investigating the reality of the company's governance and tracing the real ownership profile of the company. It means defining who materially controls the company (i.e., managers or members) and how "tamed" or, in other words, restricted members' property rights are considering the consensual agreements between members and other stakeholders. The idea that there may be situations in which courts should ownership pierce rests on the substance over form principle, which maintains that the

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> economic substance of transactions, rather than their legal form, be disclosed.

"The wisest of you men is he who has realized, like Socrates, that in respect of wisdom he is really worthless."[1]

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I. INTRODUCTION

The idea of separateness is pervasive in corporate law. However, reality often contradicts that illusion. The most salient way to explain the latter

[1] PLATO, *Socrates' Defense (Apology), in* THE COLLECTED DIALOGUES OF PLATO INCLUDING THE LETTERS 9 (Edith Hamilton & Huntington Cairns eds., 2005).

sentence is through a metaphor—*pleiotropy*. Pleiotropy is a phenomenon where genes under selection during a selective breeding for behavior also influence other traits. Pleiotropy triggers a process of metamorphosis by which what was separate is no longer.

Limited liability companies (LLCs) are units of economic development in which the legal form is highly contractual. Through the lens of pleiotropy, it is possible to comprehend that these companies' contractual frameworks impact very fundamental structural pathways in their development. One of the structural aspects of a company's development is ownership.

This paper builds upon a paradox—the paradox of ownership. Those who own are not always in control. Therefore, those who control should be held as accountable as the owners would be if they were in control.[2] In member-managed LLCs, the members undertake management. In manager-managed LLCs, the management is carried out by the managers. In many manager-managed LLCs where the managers' duties and the members' rights stem from contractual obligations determined by the company's contractual framework, there is very little real ownership or control exercised by members.

The company's contractual framework consists of the operating agreement and other hidden contracts that may set forth pre-emptive rights and other restrictions causing a *de facto* lack of marketability of members' units. In some situations, standard contractual terms give the managers exclusive decision-making power.

The role of an acting manager who had that type of exclusive power was analyzed by the Delaware Court of Chancery ("Court") in *Metro Storage International LLC v. Harron* ("*Harron*").[3] In light of the company's contractual framework, members are peculiarly vulnerable since they can neither remove the managers nor is it easy for them to sell their units. I suggest that, under these circumstances, courts may be less willing to give managers the benefit of the doubt, as done through the application of the business judgment rule.

The ownership paradox that this paper builds on is rooted in the concept of *legal pleiotropy*.[4] In this paper, legal pleiotropy refers to the expression of different ownership traits caused by the LLC's contractual features. In biology, pleiotropy is a well-established phenomenon of a single gene affecting multiple traits. I configure the LLC's operating agreement and the nexus of contracts informing the LLC as that one single gene. Legal pleiotropy means that the way constituencies and stakeholders interact in the

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[2] *See* Lécia Vicente, *Ownership Piercing*, THE CLS BLUE SKY BLOG (Apr. 9, 2021), https://clsbluesky.law.columbia.edu/2021/04/09/ownership-piercing/ [https://perma.cc/Y7BR-MULA].

[3] Metro Storage Int'l LLC v. Harron, C.A. No. 2018—0937–JTL, 2019 Del. Ch. LEXIS 272 (Del. Ch. July 19, 2019).

[4] Lécia Vicente, *The Tale of the Silver Fox: The Co-Evolution of Property Rights and Contractual Arrangements in Limited Liability Companies*, 26 S. CAL. INTERDISC. L.J. 189 (2016); Lécia Vicente, *The Hohfeldian Concept of Share in Limited Liability Companies: A View from the Common and Civil Law Traditions*, 33 TUL. EUR. & CIV. L.F. 41 (2018).

LLC generates unintended contractual consequences that impact members' property rights and the concept of ownership in this business entity at various levels.

The property rights that members hold in the LLC are hybrid. On the one hand, those property rights signal the investment position of the member (rights *in rem*). On the other hand, those same property rights are subject to governance limitations contractually defined in the LLC's operating agreement (rights *in personam*).[5] To put it differently, members' property rights are a blend of property rights and contract rights. For example, LLCs' operating agreements and default law usually restrict changes in these companies' ownership structures. As a result of those contractual restrictions, company members' ability to freely transfer their units is curtailed. Those restrictions have far-reaching effects, which I define as a manifestation of *legal pleiotropy* or variant of ownership in an LLC caused by the LLC's contractual framework.[6]

The concept of legal pleiotropy determines that physiology (scope) and morphology (structure) of property rights in LLC units are inherently altered by the contractual framework of those business entities. The far-reaching effects of legal pleiotropy turn the property rights in LLC units into a conceptual category of property rights that is different from intellectual property rights and property rights in real estate. Because of the LLC's contractual framework, the LLC members do not enjoy the freedom of contract or even the power to use, return, or transfer their units as owners of any other type of property would.

In a manager-managed LLC, if the members—"owners" of the company—cannot freely decide what to do with their investment in the LLC's units and do not fully control the company due to their ownership, who *de facto* controls it?[7] The members exert their power in the company due to their property rights in the LLC's units and can remove the managers. However, the managers are the face of the business and hold the power to administer the company because of their management duties. The equilibrium between property rights and management duties may be hard to meet, mainly because the operating agreement's contractual design is likely to affect the physiology and morphology of those property rights and the LLC's governance structure (or decision-making mechanisms).[8]

The unintended consequences of these companies' contractual setting and their effect on the members' property rights put managers and their management duties in the spotlight. In exchange for their freedom to contract on their units, members expect that managers will administer the company's

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[5] *See* Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights,* 31 J. LEGAL STUD. S373 (2002) (for a distinction between property rights (or *rights in rem*) and contract rights (or *rights in personam*)).

[6] *See supra* note 4.

[7] In the text, I use the word "control" to signify control over the company's decision-making process.

[8] For example, the operating agreement may set forth that the manager is another LLC owned and controlled by the members of the LLC that is managed.

business and further the members' interests. In this context, can managers in these business organizations excuse themselves or legitimately afford to think that they do not know how to manage members' expectations? My answer is no.

To substantiate my answer, I use *Harron*. In *Harron*, the Court considered whether personal jurisdiction should be imposed on an individual who served as a *de facto* LLC manager but was not formally designated in the LLC's agreement as such based on Section 18-109(a) of the Delaware Limited Liability Company Act (DLLCA).[9] The Court of Chancery explained that, under Section 18-402 of the DLLCA, an LLC is a member-managed entity by default unless the LLC's operating agreement sets forth differently.[10]

Therefore, by default, an LLC does not have formal managers since each member will act as a manager. If the operating agreement sets forth that the LLC is manager-managed and will have formal managers, then that fact alone does not prevent the manager-managed company from having acting managers who participate materially in the management. Otherwise, such provision would contradict Section 18-109(a) of the DLLCA, "which contemplates that any LLC, including a manager-managed LLC, can have acting managers."[11]

The main question of this article is—*what does it mean to participate materially in the management of the company? In other words, what criteria satisfy the material-participation test set forth by Section 18-109(a)(ii) of the DLLCA?* Section 18-109(a)(ii) does not provide a substantial measure for the material participation test. To use the Court's words, considering the "paucity of authority addressing the concept of material participation,"[12] I advocate that ownership piercing should be regarded as a methodological strategy that courts may resort to in situations like these.

Ownership piercing is not the same as the company's veil piercing. I define ownership piercing as a process of evaluative reasoning that courts undertake to complement the material participation test. Ownership piercing may also shed light on the level of control and the manager's decision-making role. Ownership piercing may help courts understand whether an agent occupies a control or decision-making role despite acting under the control of a principal who has the final decision-making authority. In other words, ownership piercing helps understand who exercises ultimate control in the

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[9] The Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6 §§ 18-101 to 18-1208 (1992), is often contrasted with the Uniform Limited Liability Company Act, ULLCA §§ 101-1106 (NAT'L CONF. OF COMM'RS ON UNIF. STATE LS.1996) (amended 2013). For a commentary on *Harron* and the court's analysis of the structure of the DLLCA, see Francis G. X. Pileggi, *Court of Chancery Addresses Personal Jurisdiction Over De Facto LLC Manager*, DEL. LITIG. (Aug. 1, 2019), https://www.delawarelitigation.com/2019/08/articles/chancery-court-updates/court-of-chancery-addresses-personal-jurisdiction-over-de-facto-llc-manager/ [https://perma.cc/Q6YG-ZAB4].

[10] *See* Metro Storage Int'l LLC v. Harron, C.A. No. 2018–0937–JTL, 2019 Del. Ch. LEXIS 272, at *31, *39–40 (Del. Ch. July 19, 2019).

[11] *Id.* at *39–40.

[12] *Id.* at *17.

LLC.

The court's qualified evaluative reasoning should occur when it is shown that the managers violated their fiduciary duties because they acted in a self-interested manner. The main implication of ownership piercing is that it shifts the burden of proof in the application of the business judgment rule. In other words, once the court ownership pierces to determine the extent of the managers' control of the company, the manager-defendant is the one who carries the burden of proving that they did not breach fiduciary duties.

Why should we take control seriously and define it clearly in the LLC? First, the LLC is characterized by a lack of separation of ownership and control since, by default, members are managers. Therefore, it is essential to clarify ownership in these business entities. Second, defining control and its scope, particularly in manager-managed LLCs with acting managers instead of formal managers, means determining who materially governs the company. Defining who materially governs the company means defining who owns the company in substance.

It is often the case that members have residual control of the company, while managers have actual control of it. The scope of members' rights is more limited. They are even more limited, perhaps, than what the operating agreement foresees. It is in this context that I refer to ownership piercing.[13] The doctrine of piercing the LLC veil inspires the idea of ownership piercing.[14] Both expressions appeal to the idea of an *alter ego* that affects the company's business. However, while the doctrine of piercing the LLC veil disregards the shield of the company's limited liability and determines the member be personally liable for the company's debts, I use ownership piercing to suggest courts intervene to clarify who owns property rights and substantively controls the LLC. I show under what circumstances courts should intervene to clarify who substantively controls the company. If managers substantively own the company, then they should be held to a higher standard that determines shifting the burden of proof in the business judgment rule.[15] The idea that there may be situations in which courts must

[13] *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304–05 (1983) ("The interesting problem is to determine when separation of decision management, decision control, and residual risk bearing is more efficient than combining these three functions in the same agents."). However, in most LLCs, the separation of ownership and control is blurred.

[14] Regarding the veil piercing doctrine, *see* Nella DiSanto, Comment, *Piercing the Corporate Veil to Recover Pension Payments: It's Time to Address the Issue*, 33 J. MARSHALL L. REV. 497 (2000); Dante Figueroa, *Comparative Aspects of Piercing the Corporate Veil in the United States and Latin America*, 50 DUQ. L. REV. 683 (2012); Hays C. Doan, *A Call for Clarity Resulting from Daimler Ag v. Bauman: Jurisdictional Veil Piercing in the Context of Parent and Subsidiary Corporations and the Irrelevance of Fraud or Injustice*, 38 U. ARK. LITTLE ROCK L. REV. 245 (2016); John H. Matheson & Raymond B. Eby, *The Doctrine of Piercing the Veil in an Era of Multiple Limited Liability Entities: An Opportunity to Codify the Test for Waiving Owners' Limited-Liability Protection*, 75 WASH. L. REV. 147 (2000).

[15] Ownership piercing not only differs from the veil piercing doctrine but also differs from the responsible corporate officer doctrine. *See* Martin Petrin,

ownership pierce rests on the substance over form principle. This principle maintains that the economic substance of transactions, rather than their legal form, be disclosed.[16]

In a manager-managed LLC, managers add value to the company by operating independently of the legally binding instructions they receive from the members. Ultimately, managers are employees under the definition provided by agency law.[17] They must take a common-sense approach to their work, including meeting members' demands. For instance, to make the business more attractive, they must ensure that information flows quickly. Innovation and the pursuit of new technology must be a priority in the managers' minds whether the business is small or large.[18] Members want the company to grow in value. Essentially, managers should have the will to take responsibility, the ability to take the initiative, and the capacity to add value to the company.

The contractual framework of the company I describe above often contains path-dependent legal solutions that lead to a fuzzy definition of property rights.[19] Ownership piercing entails investigating the reality of the company's governance and tracing the real ownership profile of the company. It means asking: who materially controls the company (i.e., managers or members?) and how *tamed* or limited the members' property rights are, given the consensual agreements into which members and other third parties have entered.[20]

Toward the goal of defining ownership piercing, I examine the extent to which freedom of contract is likely to enhance managers' power to the point where they materially control the company. I analyze if and how the managers' material control can be reconciled with the members' ownership or property rights. Freedom of contract is used in different ways.[21] One

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Circumscribing the "Prosecutor's Ticket to Tag the Elite"—A Critique of the Responsible Corporate Officer Doctrine, 84 TEMP. L. REV. 283 (2012). For an account of what ownership piercing is not, *see infra* Part VIII.

[16] *See* PETER HOLGATE & ELIZABETH BUCKLEY, ACCOUNTING PRINCIPLES FOR NON-EXECUTIVE DIRECTORS 44 (2009).

[17] *See* RESTATEMENT OF THE LAW (SECOND) OF AGENCY §§ 2, 220, 228, 229, 230.

[18] *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) (referring to the monitor of the team members within the team production theory). The monitor is a specialist with enough knowledge and motivation to reduce shirking in a team. However, American corporate history is littered with managers who play on both sides of the deal.

[19] *See generally supra* note 4.

[20] *See* Martin Gelter, *Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light*, 7 N.Y.U. J.L. & BUS. 641 (2011) (providing a comparative historical account of the debate about the role of managers). Although the discussion revolves around publicly held companies, the question as to whether those corporations should be run exclusively in the interests of shareholders or other stakeholders is one that also can be asked about the LLC.

[21] *See* Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1821 (1989) ("Although state corporation statutes take an "enabling" approach to many

illustrative case is in the United Kingdom where private companies serve as the counterparts to LLCs.[22] The empirical research that I developed for this article shows that, in the United Kingdom, private companies' articles of association often restrict changes to the companies' ownership structure while showcasing contractual clauses that enhance directors' power.[23] In other words, freedom of contract has been used to increase private company directors' controlling powers alongside the private companies' shareholders lock-in.[24]

The structure of this article is as follows. Section II explains the facts and the Court's arguments in *Harron.* Section III develops the concept of legal pleiotropy and the far-reaching effects of unintended contractual consequences. Section IV provides a granular discussion of the meaning of

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issues, both state and federal law governing corporations always have included a significant body of mandatory rules."); Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989); Bernard S., Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990) ("[S]tate corporate law is trivial: it does not prevent companies—managers and investors together—from establishing any set of governance rules they want. After a century of erosion through competition for corporate charters, what is left of state corporate law is an empty shell that has form but no content."); P. S. ATIYAH & R. S. SUMMERS, FORM AND SUBSTANCE IN ANGLO-AMERICAN LAW: A COMPARATIVE STUDY IN LEGAL REASONING, LEGAL THEORY AND LEGAL INSTITUTIONS (1987) (providing an overall analysis of the differences between the laws of the United Kingdom and the United States).

[22] *See* Christopher Bruner, *Opting Out of Fiduciary Duties and Liabilities in U.S. and U.K. Business Entities*, *in* RESEARCH HANDBOOK ON FIDUCIARY LAW 285 (D. Gordon Smith & Andrew S. Gold eds., 2018) (discussing the range of approaches across a number of entity types in both the United States and the U.K., including the U.K. LLP, where fiduciary duties have been found not to apply by default. Bruner also contrasts Delaware's pro-contract approach with other U.S. approaches, such as the Model Business Corporation Act for corporations and the Uniform Acts for unincorporated entities).

[23] In the United Kingdom, the managers of private companies are referred to as directors, and the members are called shareholders.

[24] This idea seems to be shared by Naomi Lamoreaux, whose research includes the study of contractual freedom in Europe and the United States in the late nineteenth and twentieth centuries. *See* Timothy Guinnane et al., *Putting the Corporation in its Place*, 8 ENTER. & SOC'Y 687, 696 (2007):

> PLLCs could also include provisions in their articles of association that made it more or less easy for members to exit, but again there was a trade-off. Although ease of exit might be a useful way of disciplining management, locking in capital could be an important way of encouraging members to make noncontractible investments. For some types of businesses the costs of minority oppression outweighed the risks of untimely dissolution, but for other types of businesses the situation was just the opposite. The great advantage of the PLLC form is that it enabled business people to choose more or less risk of oppression versus untimely dissolution as met the needs of their enterprise.

ownership that I use in this Article. Section V analyzes the relationship between ownership and control concentration, which is different between the LLC and the corporation. In contrast to the corporation, there is a high concentration of ownership in the LLC and often no separation of ownership and control. Section VI explains why the LLC is not a Berle-Means corporation. This section presents ownership piercing as a solution to overcome the LLC's individualistic purpose, the vulnerability of the agency shield, and the members' moral disengagement that derives from the fact that the LLC is not a Berle-Means corporation. Section VII defines fiduciary duties and the different ways they materialize. This section also considers the business judgment rule and links it to ownership piercing and decision-making in the company. This section argues that whenever managers exercise actual control and manipulation, courts should ownership pierce to read beyond the contractual terms and ascertain the corporate constituency that materially controls the company. If managers materially control the company as owners, then they would not be protected by the business judgment rule. Additionally, this Section taxonomizes the situations in which courts can pierce the ownership veil. Section VIII explains what ownership piercing is not. It broadens the argument beyond the LLC law to include the analysis of the operation or management test under *Reves v. Ernst & Young* and the liability of a parent company for the torts of its subsidiary under *United States v. Bestfood*. Section IX concludes by pointing in the direction of a general theory of ownership piercing that makes managers who materially manage the company more accountable for its members' hybrid property rights.

II. *METRO STORAGE INTERNATIONAL V. HARRON*

In *Harron*, the Court decided whether personal jurisdiction should be imposed over an individual who served as a *de facto* LLC manager. Indeed, the Court's argumentation is based on a systematic analysis of a *de facto* or acting manager's implied consent to personal jurisdiction.[25] Notwithstanding the procedural issues that this critical decision raises, my focus is on substantiating the concept of acting manager, which is key for applying the procedural rule outlined in Section 18109(a)(ii) of the DLLCA. Thus, I focus on assessing the type of role the defendant plays as a manager rather than on the Court's personal jurisdiction, which is a procedural matter. Deciding those procedural issues required the Court to parse out what it means to own and control an LLC.

The defendant served as a manager of the plaintiffs—the "Companies."[26] The plaintiffs contended that the defendant breached fiduciary duties and the LLC's operating agreement while serving as a manager because he pursued personal business ventures rather than the Companies' business.[27] The

[25] Pileggi, *supra* note 9.
[26] These facts are drawn from the plaintiffs' complaint described in *Harron*. *See* Metro Storage Int'l LLC v. Harron, C.A. No. 2018-0937-JTL, 2019 Del. Ch. LEXIS 272, at *3–9 (Del. Ch. July 19, 2019).
[27] *Id*.

defendant moved to dismiss the complaint for lack of personal jurisdiction.[28] He claimed that he had not been properly served because he was not the "formal manager" of the Companies, he did not occupy a "control or decision-making role," and he acted as the Companies' agent.[29] As he maintained, a person's actions in their capacity as agents cannot support an acting manager's status.[30]

In addressing the issue of personal jurisdiction and whether the defendant had been properly served in his capacity as a manager, the Court scrutinized Section 18-109(a) of the DLLCA. This provision establishes the mechanism for serving process on a manager of an LLC. Section 18-109(a) foresees that "manager" encompasses two categories: first, a person formally named as a manager in the LLC operating agreement; second, a person not formally named as a manager in the LLC operating agreement, but who, notwithstanding, participates materially in the management of the company.[31]

It is important to note that the DLLCA Section 18-401 provides that "[a] person may be named or designated as a manager of the limited liability company as provided in Section 18-101(12) of this title."[32] Section 18-101(12) maintains that "'[m]anager' means a person who is named as a manager of a limited liability company in, or designated as a manager of a limited liability company pursuant to, a limited liability company agreement or similar instrument under which the limited liability company is formed . . . ."[33]

Additionally, Section 407(c)(4) of the Uniform Limited Liability Company Act sets forth that "[a] manager may be removed at any time by the affirmative vote or consent of a majority of the members without notice or cause."[34]

Notwithstanding these provisions for managers' election and removal,

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[28] *Id.*
[29] *Id.*
[30] Metro Storage Int'l LLC v. Harron, C.A. No. 2018-0937-JTL, 2019 Del. Ch. LEXIS 272, at *1–2 (Del. Ch. July 19, 2019).
[31] DEL. CODE ANN. tit. 6, § 18-109(a) provides the following:

> As used in this subsection (a) and in subsections (b), (c) and (d) of this section, the term "manager" refers (i) to a person who is a manager as defined in § 18-101 of this title and (ii) to a person, whether or not a member of a limited liability company, who, although not a "manager" as defined in § 18-101 of this title, *participates materially* in the management of the limited liability company; provided however, that the power to elect or otherwise select or to participate in the election or selection of a person to be a "manager" as defined in § 18-101 of this title shall not, by itself, constitute participation in the management of the limited liability company.
> DEL. CODE ANN. tit. 6, § 18-109 (West 2022) (emphasis added).

[32] DEL. CODE ANN. tit. 6, § 18-401 (West 2022).
[33] DEL. CODE ANN. tit. 6, § 18-101(12) (West 2022).
[34] UNIF. LIMITED LIABILITY COMPANY ACT § 407(c)(4) (amended 2013) (UNIF. LAW COMM'N 1997).

the Court of Chancery faced several questions regarding Section 18-109(a). Was the defendant a formal or acting manager? In a manager-managed LLC, does the LLC operating agreement need to explicitly state that an individual is an acting manager of the company? Section 18-109(a) sets forth that the category of persons who serve as acting managers encompasses those who are not formally named as managers but who nevertheless "participate[] materially in the management of the limited liability company."[35]

The defendant added two layers to the material participation test to rebut the plaintiffs' claims and to demonstrate that he should not have been served: a "control or decision-making role" or "control overlay" and the "agency shield." Harron argued that "to qualify as an acting manager, the person must have occupied a "control or decision-making role."[36] He argued "that any time an LLC agreement vests authority in a formal manager, another person cannot occupy a control or decision-making role, because the formal manager has that role."[37] Regarding the agency shield, Harron claimed that "if a person participates materially in the management of an LLC while acting as an agent, then the person's actions as agent cannot support a finding of material participation because the agent is acting on behalf of his principal."[38]

The Delaware Court of Chancery held that neither of these two layers was enough to set aside the defendant's material control over the LLC. As for the control overlay, the Court found that he ran the companies' day-to-day operations and contracted on their behalf. The Court added that his responsibilities revolved around "screening opportunities, negotiating joint venture agreements, coordinating meetings with third parties, analyzing whether to make capital calls, overseeing joint venture staff, interacting with joint venture partners, and monitoring the company's performance."[39] The Court rejected the control overlay standard because it curtailed the literal or plain meaning approach that the Court applied to the interpretation of the DLLCA. In the words of the Court regarding the DLLCA's structure:

> The structure of Section 18-402 . . . counsels against applying the control overlay and against relying on a formal member designation. By contrast, reading Section 18-109(a)(ii) broadly to extend to anyone who participates materially in the business of the LLC comports with what appears to be a conscious decision by the drafters of the LLC Act to extend service beyond formal managers. The LLC Act stands alone among the Delaware entity statutes in taking this step. The statutes governing other entities—corporations, general partnerships, limited partnerships, and business trusts—apply only to formal officeholders. *Because LLCs have flexible governance structures and often*

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[35] DEL. CODE ANN. tit. 6, § 18-109 (West 2022).
[36] Metro Storage Int'l LLC v. Harron, C.A. No. 2018-0937-JTL, 2019 Del. Ch. LEXIS 272, at *2 (Del. Ch. July 19, 2019).
[37] *Id*.
[38] *Id*. at *42–43.
[39] *Id.* at *6-7.

> *operate with a relatively high degree of informality, the broader formulation enables Delaware courts to exercise personal jurisdiction over key individuals who take action on behalf of the entity.*
>
> Delaware's experience with corporate officers underscores the need for the LLC Act's reach. The implied-consent statute in the corporate context originally applied only to directors, and Delaware courts lacked the ability to exercise personal jurisdiction over senior officers. See 10 Del. C. § 3114(a); *In re Am. Int'l Gp., Inc.*, 965 A.2d 763, 778 (Del. Ch. 2009). The omission became problematic, and to fill the gap, the General Assembly extended Section 3114 to senior officers. See 10 Del. C. § 3114(b). Section 18-109(a)(ii) avoids a similar problem by enabling Delaware courts to exercise personal jurisdiction over individuals who participate materially in the business of an LLC, regardless of title, for claims relating to their actions.[40]

However, besides the statutory interpretation guidelines, the Court fell short of providing clear guidance on identifying situations in which a manager effectively runs the company's whole business, even if the LLC agreement does not designate that manager as the formal manager.

The Court also rejected Harron's argument regarding the agency shield. The Court argued that affording a special significance to the defendant's status as an agent to determine whether the defendant's actions constituted material participation in the company's management would not be in line with a plain meaning interpretation of Section 18-109(a)(ii). The Delaware Court of Chancery articulated that:

> When a defendant engages in jurisdictionally significant conduct under Section 18-109(a)(ii), *i.e.*, participating materially in the management of the LLC, and when that conduct supports a claim for which a defendant can be served under the statute, then the statute can be used to serve that person, even if the person acted as an agent of the LLC or its formal manager when engaging in the conduct. Were it otherwise, then the "very essence" of the conduct covered by Section 18-109(a)(ii)— participating materially in the management of the LLC—would become an immunity from accountability, an outcome "entirely disloyal to the statute's purpose."[41]

In sum, the Court denied Harron's defenses by applying a literal or plain meaning approach and purposive approach to the DLLCA. It further

[40] *Id.* at *41-42 (emphasis added, and citations omitted).
[41] *Id.* at *52–53.

considered that he was subject to personal jurisdiction under Section 18-109(a)(ii) because, although he was not a formal manager, he was an acting manager of the plaintiffs.

III. LEGAL PLEIOTROPY AND THE INSTITUTIONAL ANALYSIS AND DEVELOPMENT (IAD) FRAMEWORK

The term *pleiotropy* is well-established in genetics. It "refers to the phenomenon in which a single locus affects two or more apparently unrelated phenotypic traits."[42] Pleiotropy has been studied for over 100 years, and it has many guises. However, "[a]t its essence, pleiotropy implies a mapping from one thing at the genetic level to multiple things at the phenotypic level."[43] In other words, pleiotropy is the expression of multiple traits by one single gene. Those traits may or may not be related. The genes that control multiple traits are designated pleiotropic genes. Since pleiotropic genes simultaneously control multiple traits, a change or mutation in one pleiotropic gene is likely to impact more than one trait.[44]

Gregor Mendel famously referred to pleiotropy in his writing in 1866. Other authors recognized the phenomenon even before Mendel. However, the term was coined in 1910 by Ludwig Plate.[45] Since its formal description in the early twentieth century, pleiotropy has meaningfully affected the study of physiology, medical genetics, and evolutionary biology.[46] The concept of pleiotropy has played a significant role in theories of aging and facilitation, in constraints of the direction of selection, models of adaptation, speciation, human diseases,[47] and more recently in explaining unintended contractual consequences in law.[48] Pleiotropy can be apparent but also difficult to demonstrate. It may be challenging to distinguish between the close physical linkage of two distinct genes and actual pleiotropy. The challenge is even more significant when traits are not clearly defined.[49]

I use the experiment of domestication of the silver fox as an illustration of pleiotropy insofar as the findings of that experiment help explain how a single gene affects phenotypic traits in domesticated animals such as tameness, behavior, size or morphology, color, and brain composition.[50] In 1959, the

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[42] Frank W. Stearns, *One Hundred Years of Pleiotropy: A Retrospective*, 186 GENETICS 767, 767 (2010).
[43] Annalise B. Paaby & Matthew V. Rockman, *The Many Faces of Pleiotropy*, 29 TRENDS GENET 66 (2013).
[44] Regina Bailey, *What is Pleiotropy?: Definition and Examples*, THOUGHTCO. (July 11, 2019), https://www.thoughtco.com/pleiotropy-definition-4687155 [https://perma.cc/M345-9K3T].
[45] Stearns, *supra* note 42, at 767.
[46] *Id.*
[47] *Id.*
[48] *See generally supra* note 4.
[49] Stearns, *supra* note 42, at 767; *see also* Dominic Wright, *The Genetic Architecture of Domestication in Animals*, 9 BIOINFORM BIOL INSIGHTS 11 (2015).
[50] Wright, *supra* note 49, at 15. *See also* Bailey, *supra* note 44, for a description of the frizzled feather trait that is an example of pleiotropy observed in chickens.

geneticist Dmitri Belyaev initiated an experiment that used fox-breeding to study domestication effects.[51] His thesis was that sociability was dictated by genetics.[52]

To determine the extent to which genes conditioned animal amicability, Belyaev selected two types of foxes—friendly and aggressive foxes—and mated them with each other.[53] Then, he and his team would domesticate or tame them.[54] The finding was that domestication had a genetic impact which affected other traits such as fur color, tooth shape, ear and skull size, legs, tails, and behavior.[55] The tamed silver foxes would bark like dogs and be more submissive than their wild forebears.[56]

It is difficult to determine if, within the process of domestication, only one gene caused these many phenotypic traits in the silver fox. To find the right genetic path to domestication, we would have to zoom in on a map. This process is equivalent to finding the unknown address of a home on a map with several states, counties, cities, and streets.[57] However, after more than a half-century, the experiment is still ongoing.[58] The literature has provided further evidence of pleiotropy in the domestication of the silver fox.[59]

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[51] Lyudmila N. Trut, *Early Canid Domestication: The Farm-Fox Experiment,* 87 Am. Sci. 160 (1999); LEE ALAN DUGATKIN & LYUDMILA TRUT, HOW TO TAME A FOX (AND BUILD A DOG): VISIONARY SCIENTISTS AND A SIBERIAN TALE OF JUMP-STARTED EVOLUTION (2017).
[52] Katherine Wu, *What the Fox Genome Tells Us About Domestication*, SMITHSONIAN MAGAZINE (Aug. 8, 2018), https://www.smithsonianmag.com/smithsonianmag/what-fox-genome-tells-us-about-domestication-180969931/ [https://perma.cc/35DS-PC52].
[53] Trut, *supra* note 51, at 163—64.
[54] *Id.* at 163–64.
[55] *Id.* at 164.
[56] *Id.* at 164. *See also* Vicente, *The Tale of the Silver Fox*, *supra* note 4, at 207.
[57] Wu, *supra* note 52.
[58] *See* Anna V. Kukekova et al., *Mapping Loci for Fox Domestication: Deconstruction/Reconstruction of a Behavioral Phenotype,* 41 BEHAV GENET 593 (2011).
[59] Wright, *supra* note 49, at 15:

> Perhaps the best evidence for pleiotropy is the correlations that exist between separate components of the domestication syndrome when domestication is recreated through selection lines. The most wellknown of these selection lines was based on the silver fox and consisted of directional selection solely based on tameness and aggression. It was found that after only 8–10 generations, color changes appeared (yellowing and piebaldness), adults maintained the juvenile floppy ears, skull changes occurred (leading to short and wide faces), as did curly tails. These results suggest that selection on a single behavioral trait can lead to a range of morphological changes. In a similar experiment, rats also divergently selected for tameness/aggression exhibited changes in neurotransmitters, hormone levels, and morphology. These studies imply that the loci for tameness show pleiotropic effects on multiple different domestication syndrome traits,

I compare the expression of multiple ownership traits in the LLC caused by the LLC's contractual framework to pleiotropy. I call this analogy *legal pleiotropy*.[60] Contract law, specifically, the LLC's operating agreement, tames or affects members' property rights when it imposes restrictions on their exercise.[61] Those property rights are tamed because members cannot exercise them against the world (*erga omnes*) due to their scope being limited by the company's contractual design. If the company's contractual design turns members' property rights into something akin to personal rights (rights *in personam*), then that would be a manifestation of legal pleiotropy.[62]

I provide one example of legal pleiotropy—the expression of multiple traits of ownership as a result of the company's contractual framework. Suppose the managers *de facto* control the company when the allocation of such control is not entirely consistent with the operating agreement. The managers' control under such circumstances is caused by other hidden contracts that also constitute the LLC's contractual framework. Although not consistent with the operating agreement, managers who are personally invested in the company's business act like actual company owners. However, in the operating agreement, the members are the ones formally defined as the "owners." Managers can act like company owners because hidden contracts allocate power to the managers and create members' fuzzy or weak property rights.

Nevertheless, I analogize with parsimony. Following authors such as Dominic Wright[63] and Anna Kukekova,[64] who have analyzed the multiple phenotypic traits caused by pleiotropic genes in domestication, I understand that pleiotropy's mode of operation and the genes involved are not yet fully established. Likewise, legal pleiotropy needs to be continuously studied, particularly to determine the applicable contractual clauses' scope and depth. It is important to understand the extent to which such clauses restrict members' property rights and the unintended consequences of such clauses

> though in these instances close linkage between different genes affecting each trait could also be a potentially plausible explanation. [citations omitted]

[60] The idea of legal pleiotropy can be used to explain a long-standing phenomenon of erosion of entity formalism in corporate law. In this context, *see* June Carbone & Nancy Levit, *The Death of the Firm*, 101 MINN. L. REV. 963 (2017). More recently, Mariana Pargendler and George Georgiev have focused on the phenomenon of erosion of entity formalism in the context of corporate groups. I thank them for the discussion on this topic.

[61] *See* Joan MacLeod Heminway, *The Ties That Bind: LLC Operating Agreements as Binding Commitments*, 68 SMU L. REV. 811 (2015) (providing insights into the status of operating agreements as contracts).

[62] *See* Hansmann & Kraakman, *supra* note 5, at S405.

[63] *See* Wright *supra* note 49, at 16 ("To truly define pleiotropy, however, the actual causal mutation/polymorphism must be identified. In this instance, it is possible to identify genuine pleiotropic effects. Unfortunately, as shown earlier, the identification of such loci is extremely rare.").

[64] *See* Kukekova, *supra* note 58.

on the company's ownership structure and governance.[65]

The Institutional Analysis and Development (IAD) framework developed by Elinor Ostrom and her co-authors is a promising approach to institutional arrangements involving the LLC.[66] The IAD framework facilitates a polycentric approach to LLC law that enables us to recognize multiple different types of rules with shared and overlapping authority in construing this business entity's legal framework. Furthermore, the IAD framework draws our attention to contextual variables, such as culture, economics, and politics, which can influence LLCs' design and performance outcomes.

A distinctive feature of institutional analysis is the focus on rules. Rules can be formal (e.g., statutes, regulations, ordinances), or informal (e.g., behavioral norms, rules governing organizational relationships). I focus on the contractual rules of the operating agreement that influence the interactions between different constituencies, namely managers and members. The rules outlined in the operating agreement are nested in another set of rules—default rules—that define how the operating agreement rules can be designed. Therefore, my analysis is multilayered. I recognize that the way the LLC functions depends on the legislative design of those default rules which determine how LLCs interact with related institutions. Acknowledging this interconnectedness is vital because, in order to comprehend LLCs' legal framework and how they function, one must understand how the various rules interact with one another. Legal pleiotropy is the conceptual construct that I offer to explain those rule interactions.

IV. Ownership and the Law of Business Organizations

The concept of ownership is complex and has been contested in the context of business entities. Some of the major theoretical approaches express skepticism that it can be coherently applied in this context (basically rejecting the notion that business entities with distinct legal personality are amenable to being owned in a straightforward way). In other words, the entity owns the assets, and the equity holders own stock or membership units as the case may be, but no one owns the entity as such.[67]

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[65] *See* Benito Arruñada, Giorgio Zanarone & Nuno Garoupa, *Property Rights in Sequential Exchange,* 35 J.L. ECON. & ORG. 127 (2019).

[66] *See* Elinor Ostrom, *The Institutional Analysis and Development Framework and the Commons*, 95 CORNELL L. REV. 807 (2010); Elinor Ostrom, *Background on the Institutional Analysis and Development Framework,* 39 POL'Y STUD. J. 7 (2011). *See* Mark T. Imperial, *Institutional Analysis and Ecosystem-Based Management: The Institutional Analysis and Development Framework,* 24 ENV'T MGMT. 449 (1999).

[67] I thank Christopher Brunner for his comments on this issue, which I replicate here. *See* Louis Putterman, *Ownership and the Nature of the Firm*, 17 J. COMPAR. ECON. 243 (1993) (framing the discussion of the ownability of the firm within the theory of the firm); Bengt R. Holmström, *The Firm as a Subeconomy,* 15 J.L. ECON. & ORG. 74 (1999) (explaining theoretical models that approach the ownership of assets by the firm as opposed to the ownership of assets by individuals); REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND

Conversely, Henry Hansmann, in *The Ownership of Enterprise,* provides a theory of enterprise ownership based on an economic and comparative analysis.[68] Hansmann refers to "formal rights of control" of the business enterprise as "ownership" and clarifies, for the most part in line with Adolf Berle and Gardiner Means, that formal control does not necessarily mean the enterprise's "effective control."[69]

In this section, I specify the aspects of the members' position in terms of ownership that this article addresses. This clarification will illuminate the meaning of ownership that is central to this article. Additionally, specifying the members' position in terms of ownership will help clarify essential elements of the argument, namely: first, how ownership relates to control, and specifically why varying levels or forms of control should be analyzed by reference to the relevant conception of ownership for purposes of assigning liability; second, how I apply the concept of pleiotropy and what the relevant "gene" is when I apply this concept by analogy in the legal context.

Henry Hansmann and Reinier Kraakman explain that the idea that property rights cannot be divided "is most conspicuous in the civil law countries of Europe, which since the nineteenth century have adhered self-consciously to a "unitary theory of property rights" under which, as a general rule, all property rights in an asset must be concentrated in the hands of a single owner rather than divided into partial rights shared among two or more persons."[70]

The restrictions on the division of property rights configure a *numerus clausus*.[71] It is important to stress that such restrictions are not unique to Europe. The restrictions are also imposed by common law to varying degrees. The law of business organizations is an exception to this idea of *numerus clausus*, inherent to the definition of property rights. In other words, the law of legal entities (corporations, LLCs, partnerships, and trusts) can be less conservative when it comes to recognizing partial property rights.

At its core, organizational law is property law as Hansmann and Kraakman posit. They articulate that "organizational law permits the owners of a business to partition off the assets used in the business into a separate pool, distinct from the owners' personal assets, for purposes of pledging those assets to creditors." This is the essence of "affirmative asset partitioning."[72]

FUNCTIONAL APPROACH 13–15 (3d ed. 2017) (clarifying the scope of investor ownership and the concept of investor-owned company); David Ciepley, *The Anglo-American Misconception of Stockholders as 'Owners' and 'Members': Its Origins and Consequences,* 16 J. INST. ECON. 623 (2020) (criticizing the assumption that stockholders "own" the corporation, which, the author acknowledges, is a principal support of "shareholder primacy" in the United States).

[68] HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996).

[69] *Id.* at 11–12; *see also* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1968) (1932).

[70] *See* Hansmann & Kraakman, *supra* note 5, at S375.

[71] *See* MARY ANN GLENDON ET AL., COMPARATIVE LEGAL TRADITIONS: TEXTS, MATERIALS AND CASES ON WESTERN LAW 375–76 (4th ed. 2014).

[72] Hansmann & Kraakman, *supra* note 5, at S405–06.

However, sorting out just what ownership means in this context is fundamental. Generally, to define ownership, the law considers who is making the claim, their interest, and their purpose by making that claim. Still, ownership can be ambiguous. Honoré explains that ownership is traditionally defined as a bundle of rights.[73] However, he stresses that ownership is more than that, and outlines eleven incidents of ownership to provide a clearer explanation of the term (*the right to possess, the right to use, the right to manage, the right to the income of the thing, the right to the capital, the right to security, the rights or incidents of transmissibility and absence of term, the prohibition of harmful use, liability to execution, and the incident of residuality*).[74]

The ambiguity of ownership is also stressed by Michael Heller and James Salzman who define ownership according to a set of six maxims (*first come, first served; possession is nine-tenths of the law; you reap what you sow; my home is my castle; our bodies, our selves; the meek shall inherit the earth*) that owners can use to make others do what they want them to do, particularly in a dynamic where resources are scarce. Given that those maxims are selected depending on the circumstances, ownership, Heller and Salzman posit, is always up for grabs.[75] If this is true, then the understanding that a company as a legal entity can be owned by one particular constituency is not straightforward.

Adolf A. Berle and Gardiner C. Means, referring to the "quasi-public corporation" maintained that "[i]t has destroyed the unity that we commonly call property—has divided ownership into nominal ownership and the power formerly joined to it."[76] They perceive the traditional meaning of ownership as the right of an individual to use their own property as they see fit and to receive the fruits of its use.[77] Building on Berle's and Means' perception of

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[73] *See* A.M. HONORÉ, *Ownership*, *in* THE NATURE AND PROCESS OF LAW: AN INTRODUCTION TO LEGAL PHILOSOPHY 370 (Patricia Smith ed., 1993).
[74] *Id.* at 371–75.
[75] *See* MICHAEL HELLER & JAMES SALZMAN, MINE!: HOW THE HIDDEN RULES OF OWNERSHIP CONTROL OUR LIVES (2021).
[76] *See* BERLE & MEANS, *supra* note 69, at 7.
[77] The traditional conception of ownership exposed in the text is not substantively different from the definition of ownership provided by Article 544 of the French Civil Code that sets forth as follows: "Ownership is the right to enjoy and dispose of things in the most absolute manner, provided they are not used in a way prohibited by statutes or regulations." ("La propriété est le droit de jouir et disposer des choses de la manière la plus absolue, pourvu qu'on n'en fasse pas un usage prohibé par les lois ou par les règlements.") Additionally, Article 545 of the French Civil Code provides that "[n]o one may be compelled to yield his ownership, unless for public purposes and for a fair and previous indemnity." ("Nul ne peut être contraint de céder sa propriété, si ce n'est pour cause d'utilité publique, et moyennant une juste et préalable indemnité."). Article 546 sets forth that "[o]wnership of a thing, either movable or immovable, gives a right to everything it produces and to what is accessorily united to it, either naturally or artificially. That right is called right of accession." ("La propriété d'une chose soit mobilière, soit immobilière, donne droit sur tout ce qu'elle produit, et sur ce qui s'y unit accessoirement soit naturellement, soit artificiellement. Ce droit s'appelle "droit

the traditional concept of ownership, I understand that ownership has been construed as a representation that has long encompassed spiritual values such as the immediate and direct satisfaction that an owner would enjoy from using and shaping their physical property, apart from the profits they would earn.[78] Substance, power, and control are functions of ownership.

The corporation turns the concept of ownership upside down. Berle and Means acknowledge this by reflecting on the separation of ownership and control in the publicly held corporation. Here, the equity holder only holds a mere symbol of ownership. In the corporate setting, substance refers to the profits the equity holder is entitled to. Power alludes to the equity holder's right to vote and elect the management. Control is a function of ownership that determines responsibility or accountability. In this article, by referring to ownership, I refer to these three functions—substance, power, and control.[79]

In the LLC, the contractual design of the operating agreement and other hidden contracts that form the company's contractual framework may determine that the functions of ownership, particularly power and control, be transferred to the managers. Hence, the operating agreement and other specific contractual clauses may cause ownership and the position of the members in the company to gain different configurations. In this context, the operating agreement and specific contractual clauses operate as pleiotropic genes.

Interestingly, Honoré notes that there seems to be a generalized understanding that ownership may assume different expressions. He says:

> Many observers have drawn attention to the growth of managerial power divorced from legal ownership; in such cases it may be that we should speak of split ownership or redefine our notion of the thing owned. This does not affect the fact that the right to manage is an important element in the notion of ownership; indeed, the fact that we feel doubts in these cases whether the 'legal owner' really owns is a testimony to its importance.[80]

The new variants of ownership triggered by contract find their expression in property rights with a different morphology and physiology. Herein lies one of the traits of *legal pleiotropy*. Legal pleiotropy determines the emergence of new types of property rights in the realm of the LLC. This phenomenon illustrates Hansmann and Kraakman's argument which states that the law of

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d'accession"").

[78] *See* BERLE & MEANS, *supra* note 69, at 64–65.

[79] *See* Henry Hansmann, *Ownership of the Firm,* 4 J.L. ECON. & ORG. 267, 269 (1988) (defining owners as "those persons who share two formal rights: the right to control the firm and the right to appropriate the firm's residual earnings."); Putterman, *supra* note 67, at 245 (defining ownership as "a bundle of rights that an economic agent is entitled to exercise over an asset. Its main components are the right of utilization, the right to the products of the asset, and the right to alienate or dispose of the asset and of these rights of utilization and return.").

[80] *See* Honoré, *supra* note 73, at 372.

business organizations is an exception to the principle of *numerus clausus* that characterizes the definition of property rights. New expressions of ownership and variants of property rights in business organizations are unlimited since it is difficult to predict to what extent the pleiotropic features of the company's organic documents and specific contractual clauses will trigger unintended consequences. In the LLC, the possibilities are countless.

V. HYBRID PROPERTY RIGHTS AND OWNERSHIP PIERCING

An article in the *Wall Street Journal* dated as of 1917 (a time when there were no LLCs in the United States) noted that:

> Theoretically, and even in practice, if directors direct and stockholders exercise their voting privilege, the limited liability corporation is almost an ideal democracy.[81] It is clear that if the stockholder does not receive fair play from the management, he has largely himself to thank. He is protected, if in no other way, by the courts and the channels of publicity.[82]

American corporate law has come a long way since 1917. It is filled with cases where directors play on both sides of the deal due to the effective control they have over the company.[83] Therefore, today, in light of recent developments in corporate law and corporate governance in the United States and Europe,[84] the above-noted 1917 statement alluding to the democratic purpose of the corporation may sound unwarranted. The same caution should apply in defining the LLC as a democratic undertaking.

The LLC is a business entity with contractual features that functionally determine different ownership forms. The LLC's contractual features are set

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[81] The esteemed reader should note that the concept of "limited liability corporation" referred to in the text is not a type of LLC. It is an old reference to a corporation specifically noting the limited liability feature which is now used to define these business entities. Regarding the concept of limited liability, see STEPHEN M. BAINBRIDGE & M. TODD HENDERSON, LIMITED LIABILITY: A LEGAL AND ECONOMIC ANALYSIS (2018).

[82] *A Difficult Problem*, WALL ST. J., Oct. 29, 1917, at 1.

[83] J. Travis Laster, *Revlon is a Standard of Review: Why It's True and What It Means*, 19 FORDHAM J. CORP. & FIN. L. 5, 17 (2013) (citing Delaware case law to maintain that Delaware "does not "ignore the reality that American business history is littered with examples of managers who exploited the opportunity to work both sides of the deal.").

[84] See Hank Gilman, *Lessons From Enron 15 Years Later: The Greatest Fraud Trial Ever*, NEWSWEEK (Jan. 24, 2021, 7:00 AM), https://www.newsweek.com/lessons-enron-15-years-later-greatest-fraud-trial-ever-opinion-1563023 [https://perma.cc/NW7K-82N9]. *See also* Ryan Browne, *'The Enron of Germany': Wirecard Scandal Casts a Shadow on Governance,* CNBC (June 29, 2020, 5:22 AM), https://www.cnbc.com/2020/06/29/enron-of-germany-wirecard-scandal-casts-a-shadow-on-governance.html [https://perma.cc/6Z7X-F3AZ].

forth by the respective operating agreement, which may also enhance the managers' powers or the members' rights depending on how it is contractually designed.[85] In other words, considering the *Wall Street Journal*'s citation above, the LLC will be as democratic as the operating agreement determines it to be. Several LLC lawsuits are essentially like the *War of the Roses* for individual members. In multiple instances, like *Harron*, the contractual framework of the LLC ignites disputes that revolve around allegations of self-dealing, theft, oppression, and betrayal.[86]

Given the picture above, it is crucial to differentiate member-managed from manager-managed companies in the LLC context. In member-managed companies, all members are managers. In manager-managed companies, only designated members or non-members or a combination of the two are managers. As a reminder, this article primarily focuses on manager-managed LLCs. Furthermore, the LLCs' operating agreements often provide definitions of *members*. The operating agreements define members in terms of their ownership and their limitations on the exercise of that ownership, particularly regarding the company's governance. Herein, I examine the consequences that the limitations of the exercise of the members' ownership have on the definition of those members' property rights.

The influence and control that managers wield in the LLC is undeniable.[87] The managers' role in the LLC is to protect the interests of the company and the members. However, managers often engage in self-dealing, which hurts the company's business and its members' interests. In this scenario, members' property rights are weak. They are not in control; managers are.[88]

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[85] Regarding the contractual design of business organizations, *see* D. Gordon Smith, Matthew Wright & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws,* 80 FORDHAM L. REV. 125 (2011) (expanding shareholders' participation in the public-held corporation through the contractual design of the corporations' by laws); Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. L. REV. 216 (1992) (advancing a theory of gap-filling in the close corporation contract); Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 CAL. L. REV. 373 (2018) (arguing that the contractual features of the corporation create an imbalanced relationship between shareholders and directors because shareholders' power to enact and amend bylaws is more limited than the power that directors have to adopt or amend bylaw provisions).

[86] On a Twitter thread, Jessica Erickson makes similar observations regarding her own research of the corporation. *See* Jessica Erickson (@ProfJErickson), TWITTER (May 21, 2021, 11:58 AM), https://twitter.com/ProfJErickson/status/1395786191182696448.

[87] *See Marx v. Morris*, 925 N.W. 2d 112 (Wisc. 2019); *Metro Storage Int'l LLC v. Harron,* 275 A.3d 810 (Del. Ch. 2022); *XOtech, LLC v. United States*, 142 Fed. Cl. 313, 314 (2019); *Llamas v. Titus*, No. CV 2018–0516–JTL, 2019 WL 2505374 (Del. Ch. 2019)*; Cruickshank v. Dixon (In re Blast Fitness Grp., LLC)*, 602 B.R. 208 (Bankr. D. Mass. 2019); *Obeid v. Hogan*, 2016 Del. Ch. LEXIS 86, 2016 WL 3356851 (Del. Ch. 2016).

[88] *See Gay Jenson Farms Co. v. Cargill, Inc*. 309 N.W. 2d 285 (Minn. 1981) (This is a case of application of the law of agency. It raises fundamental questions about who exercises *de facto* control over the company. Furthermore, the Court discusses

Against this backdrop, where the company's constituencies have an uneven influence in the company, I deal with the relationship between members and managers. Members' influence translates into the degree to which the company is dependent on them. The company's independence vis-à-vis its members' influence is indicated by the number of members in the company and, more importantly, by the type of ownership they have. The managerial influence reflects the managers' level of control in the company, vis-à-vis the members' influence.

To define the relationship between members and managers, I construe ownership piercing as a test to protect members' interests as opposed to third parties.[89] The test consists of an act of evaluative reasoning by which courts subjectively analyze the contractual framework of the company to define who effectively owns the business enterprise for purposes of accountability.

Despite its functionality, this test is not an alternative to fiduciary protections. The contractual arrangements that inform the company are a source of unintended consequences that originate new expressions of ownership. Those contractual arrangements may limit the substance function of the members' ownership and determine that the power and control functions of their ownership be inadvertently transferred to the managers. This phenomenon loops us back to the metaphor of legal pleiotropy. Given this unexpected turn of events in the LLC caused by contracts, the test for ownership piercing is fundamentally a normative critique of excessive deference to contractual freedom in the law of LLC.

This test surmounts the divergence between the Delaware Limited Liability Company Act and the Uniform Limited Liability Company Act postures on waiver of fiduciary protections in unincorporated entities. The drafters of the Uniform Limited Liability Company Act remain reluctant to go as far as Delaware has in permitting the total elimination of fiduciary protections, resulting in purely contractual relationships.[90]

The test for ownership piercing transcends the Delaware-specific debate regarding whether fiduciary protections should even apply by default. Although Delaware now makes it clear that they do, Myron Steele at one time argued that pure contract should be the default position,[91] while Lyman Johnson argued that the statutory capacity to waive fiduciary protections may not even be constitutional in Delaware to the extent that it treads upon the Court of Chancery's equitable prerogative.[92]

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if a creditor who assumes control of its debtor's business becomes liable as a principal for the debtor's acts in connection with the business. This case brings to mind other questions. For instance, can creditors become the business owners without the accompanying legal indicia? This case is relevant for this article because it helps cater to the idea of form versus substance that feeds into the need to distinguish ownership from control in the LLC).

[89] *See* discussion *infra* Part VI, C.

[90] I thank Christopher Bruner for his suggestions and comments on this issue.

[91] *See* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies,* 32 DEL. J. CORP. L. 1 (2007).

[92] *See* LYMAN JOHNSON, THREE FIDUCIARIES OF DELAWARE CORPORATE LAW — AND EISENBERG'S ERROR, *in* FIDUCIARY OBLIGATIONS IN BUSINESS 57 (Arthur B.

The test for ownership piercing counterbalances Delaware's more general willingness to rely on contractual protections in various closely held business contexts. For example, in *Nixon v. Blackwell*, the Supreme Court of Delaware rejected the application of special fiduciary protections in closely held corporations, reflecting Delaware's broader pro-contract posture across various types of entities.[93]

Besides redefining the relationships between members and managers, legal pleiotropy also changes how ownership and control interrelate in the LLC. Although there are publicly traded LLCs in the US (with a controlling member), the LLC's ownership structure is generally concentrated in a few members. However, the company's ownership structure should be analyzed against the management board's structure since the company's contractual framework may determine that managers ultimately control the company.

Legal pleiotropy delineates the various ways in which the interrelation between ownership and control may occur. The co-occurrence or pattern of change on which the relationship between ownership and control is based depends on the LLC's contractual setting set forth by the operating agreement and other contracts. The unexpected correlation between ownership and control deriving from the contractual features that inform the company is a manifestation of legal pleiotropy.

The operating agreements may set forth clauses by which they clothe members with the power to appoint one or more individuals to act on their behalf at the management board's meetings. The operating agreements may describe how the members and managers will share managing tasks. In these circumstances, there exist cases in which members retain all authority and control over the company's assets but delegate specific authority to the management board or, eventually, to a board of trustees. The operating agreements may set forth that the members (in particular if it is a sole member) may retain the power to unilaterally take any and all actions required to, among other things, effectuate the capitalization, merger, acquisition, consolidation, liquidation, or dissolution of the company or any amendment, change, modification, and admit new members to the company on such terms as may be established by the members. From an economic perspective, operating agreements may provide members with managing and controlling powers over their investment return.

Nevertheless, in many circumstances, the operating agreements grant considerable control to the managers. Members keep statutory control rights that derive from their property rights in the company's units. One of those statutory rights of control allows members to limit changes to the ownership structure of the company. However, those limitations may not be sufficient in empowering members when managers take the lead in formulating the business objectives and strategy or negotiating joint ventures with other companies.

As they did in *Harron*, the companies' operating agreements may set forth that the manager has exclusive authority to manage the company's

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Laby & Jacob Hale Russell eds., 2021).

[93] Nixon v. Blackwell, 626 A.2d 1366, 1369 (Del. 1992).

operations and affairs and to make all decisions regarding the company's business.[94] In *Harron*, members did not have a right to vote upon or otherwise make any decisions relating to the company's operation, except as might have been otherwise expressed in the operating agreement.[95] In other words, this case echoes the idea that freedom of contract tends to enhance the managers' control in a manager-managed company.

The operating agreement can determine that members can neither participate in the management or control of the company's business or transact any business for the company, nor will they have the power to act for or bind the company since the manager is solely and exclusively vested with those powers.[96] Despite the actions for which the manager must seek the unanimous approval of the members because they may profoundly impact the sustainability of the company (e.g., dissolution, mergers and acquisitions, termination of the mandate or replacement of the manager, admission of a new member, or amendment of the LLC agreement) the manager is the face of the business.

It is apparent that the company's contractual features affect the scope of the members' property rights, and, for that reason, their property rights are hybrid—they are a mixture of property rights (rights *in rem*) and contract rights (rights *in personam*).[97] This hybridity spells out the idea that members' property rights are limited and may not be straightforward, given the combination of corporate law and contract law elements in the LLC. In a manager-managed LLC, where the contractual framework determines that members do not intervene in the company's management by any means and have very little control, it is pressing to define who *de facto* owns the company.[98]

This pressing need exists because it is crucial not just to determine the property rights members hold in their units but also to make managers accountable for their decisions. Lifting the veil over the company's ownership structure allows the court to interfere in the company's contractual arrangements to better define members' property rights and perceive the extent to which the manager materially governs the company, even if that manager is not formally appointed as such in the operating agreement.

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[94] Metro Storage Int'l LLC v. Harron, C.A. No. 2018–0937–JTL, 2019 Del. Ch. LEXIS 272, at *4–6 (Del. Ch. July 19, 2019).

[95] *Id.* at *4.

[96] *See* Uniform Limited Liability Company Act, ULLCA §§105(a)(2) (NAT'L CONF. OF COMM'RS ON UNIF. STATE LS 1997) (amended 2013) ("Except as otherwise provided in subsections (c) and (d), the operating agreement governs: the rights and duties under this [act] of a person in the capacity of manager.").

[97] *See* Hansmann & Kraakmann, *supra* note 5.

[98] In the text, I stress the functional role that the company's contractual framework plays in limiting the rights of the company's members. The members still hold a crucial part in hiring managers and fundamental decisions for the company's sustainability, such as mergers and acquisitions, sale or acquisition of real estate, contracting loans, and other transactions.

VI. THE LLC IS NOT A BERLE-MEANS CORPORATION

A. *Why is the LLC Not a Berle-Means Corporation?*

In 1932, besides pointing out the corporation's increasingly political role, Berle and Means introduced us to the idea of separation of ownership and control in the corporation. The notion of separation of ownership and control remains the paradigm of US publicly held corporations today.[99]

Berle and Means' findings are now considered intuitive. There are, however, circumstances that are not favorable to the development of a Berle-Means corporation. Some of those circumstances involve the LLC. The LLC is not a corporation. Indeed, most of the corporations are not of the Berle-Means type. In this regard, Joshua Fershée has called our attention to the LLC's misconception even by the Supreme Court of the United States (SCOTUS). In *Daimler AG v. Bauman*, SCOTUS referred to a Delaware LLC as a "limited liability corporation."[100] Fershée noted that:

> Many courts thus seem to view LLCs as close cousins to corporations, and many even appear to view LLCs as subset or specialized types of corporations. A May 2011 search of Westlaw's "ALLCASES" database provides 2,773 documents with the phrase "limited liability corporation," yet most (if not all) such cases were actually referring to LLCs—limited liability companies. As such, it is not surprising that courts have often failed to treat LLCs as alternative entities unto themselves. It may be that some courts didn't even appreciate that fact. (Footnotes omitted)[101]

The LLC is not a Berle-Means corporation because it challenges the paradigm of separation of ownership and control. Most LLCs show no membership diversification and a lower level of separation of ownership and control. Another element to consider is the correlation between ownership concentration and control. Typically, ownership is concentrated in the LLC since the LLC's units are not usually publicly traded. Concentrated ownership, uniform membership, and lower levels of separation of

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[99] *See* BERLE & MEANS, *supra* note 69; Fama & Jensen, *supra* note 13, at 323 (defining separation of ownership and control as "the separation of residual risk bearing from decision management.").

[100] Daimler AG v. Bauman, 134 S. Ct. 746, 752, 187 L. Ed. 2d 624 (2014).

[101] See Joshua P. Fershee, *LLCs and Corporations: A Fork in the Road in Delaware?,* 1 HBLR ONLINE 86 (2011). *See also* this author's commentary, Joshua Fershee, *Wrong: U.S. Supreme Court & 4575 Other Cases Say an LLC is a Corporation*, BUSINESS LAW PROFESSOR BLOG (Sept. 8, 2015), https://lawprofessors.typepad.com/business_law/2015/09/the-us-supreme-court-doesnt-know-an-llc-is-a-limited-liability-company.html [https://perma.cc/UZ9V-MWM9].

ownership and control are the characteristics that explain the distancing of the LLC from the Berle-Means corporation model.

B. *The Implications of the LLC Not Being a Berle-Means Corporation: The Individualistic Purpose of the LLC, the Vulnerability of the Agency Shield, and Moral Disengagement*

The recognition that the LLC is not a Berle-Means corporation amounts to three aspects—the LLC's individualistic purpose, the agency shield's vulnerability, and the moral disengagement of the LLC's members.

1. *The Individualistic Purpose of the LLC*

Despite the LLC's *intuitu personae* nature, which refers to its relational purpose, disputes between majority and minority members and between members and managers are common. The LLC rose in popularity after a tax reform in the late 1990s.[102] The LLC's rising popularity led to increased disputes among members and members and managers. The lack of clarity regarding the scope of fiduciary duties ignited the LLC litigation.[103]

When members simultaneously assume managers' roles, members prefer to assign the managing tasks to more activist members, generally majority members. Even when all members manage the company, there are situations in which minority members cannot take their share of control in the company. This phenomenon is not new. The literature has thoroughly explored it in the context of the Berle-Means corporation, agency costs, and fiduciary duties.[104]

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[102] *See* Robert R. Keating et al., *The Limited Liability Company: A Study of the Emerging Entity,* 47 BUS. LAW. 375 (1991); Daniel S. Goldberg, *The Tax Treatment of Limited Liability Companies: Law in Search of Policy,* 50 BUS. LAW. 995 (1995); Larry E. Ribstein, *The Emergence of the Limited Liability Company,* 51 BUS. LAW. 1 (1995); Joan MacLeod Heminway, *Fundamental Changes in the LLC: A Study in Path-Divergence and Convergence*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (Robert W. Hillman & Mark J. Loewenstein eds., 2015).

[103] *See* Emily J. Gill*, Hey! That's My LLC!: The Importance of Looking to Facts, Not Initial Reports, to Resolve Membership Disputes in Louisiana Member-Managed LLCs,* 74 LA. L. REV. 937 (2014); James R. Burkhard, *Resolving LLC Member Disputes in North Carolina*, 37 CAMPBELL L. REV. 225 (2015); Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883 (2005). *See also* Achaian, Inc. v. Leemon Family LLC, 25 A.3d 800, 2011 WL 3505361 (Del. Ch. 2011); Skye Mineral Inv'rs, LLC v. DXS Capital (U.S.) Ltd., CV 2018–0059–JRS, 2020 WL 881544 (Del. Ch. 2020); Gatz Properties, LLC v. Auriga Capital Corp., 59 A. 3d 1206, 2012 WL 5425227 (Del. 2012); Sanctuary Capital, LLC ex rel. N. Louisiana Bidco, LLC v. Cloud, 336 So. 3d 1040, 2022 WL 1010312 (La. App. 2 Cir. Apr. 15, 2015); Anderson v. Wilder, 2003 WL 22768666 (Tenn. Ct. App. 2003).

[104] *See* Kenneth E. Scott, *Agency Costs and Corporate Governance*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 26–30 (Peter Newman ed., 2002) (providing a general approach to agency costs, corporate governance and

However, the prevalence of the relational element, the lack of a market for the units capable of pressuring the managers to run the extra mile for the company, for the members, or any other "residual claimant,"[105] and the low

fiduciary duties in the United States, Japan, and Germany). *See also* STEFAN GRUNDMANN, EUROPEAN COMPANY LAW: ORGANIZATION, FINANCE AND CAPITAL MARKETS 49–52 (2d ed. 2012) (referring to the need to restrict freedom of contract when there are collective action problems in public limited liability companies); Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1 (2006); Benjamin Means, *A Voice-Based Framework for Evaluating Claims of Minority Shareholder Oppression in the Close Corporation*, 97 GEO L.J. 1207, 1212 (2009) (arguing that "courts should (1) embrace the principle that the appropriate level of judicial scrutiny [for shareholder oppression claims] may vary and (2) use minority shareholder participation in governance to determine the proper level of scrutiny. If the minority lacks a voice in the business, courts should apply enhanced scrutiny, accepting general pleadings and requiring controlling shareholders to show a legitimate business purpose for challenged conduct."); F. Hodge O'Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121 (1987) (outlining the most frequent causes of dissension among shareholders in a close corporation; mentioning the techniques used by controlling shareholders to eliminate minority shareholders from an enterprise or otherwise oppress them; and referring to the rights and tactics minority shareholders can use to protect their interests, and advance planning and contractual arrangements that protect minority shareholders); Cyril Moscow & Norman C. Ankers, *Oppression of Minority Shareholders*, 77 MICH. B.J. 1088 (1998) (reviewing the history of common law and statutory provisions that may provide overlapping remedies available to shareholders asserting claims that persons in control of corporations have abused them); Kenneth K Mwenda & Adam Wiseberg, *Corporate-Law Safeguards against Oppression of Minority Shareholders*, 11 S.A.M. L.J. 28 (1999) (taking steps to analyze the common law's position regarding minority shareholder protection in the United Kingdom. The article also discusses other common law jurisdictions (i.e., the U.S. and Canada) that face the dilemma of performing a "balancing act" between minority shareholders and the power of corporations to do business).

[105] *See* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration,* 94 J. POLITICAL ECON. 691, 695 (1986) (providing a theoretical model that starts from the assumption that "the owner of an asset has the residual rights of control of that asset, that is, the right to control all aspects of the asset that have not been explicitly given away by contract."). *See also* Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266 (1999) (conciliating the nexus of contracts theory that encompasses several categories of claimants with the standard law and economics view that corporations and their board of directors owe fiduciary duties only to shareholders.); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POLITICAL ECON. 288, 291–292 (1980) (explaining how the labor market influences rental rates for managers' human capital depending on their performance in the firm). Not entirely coincident with my arguments in the text, *see* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 275–277 (1986) (saying that "[i]lliquidity is not the problem." However, they explain four ways in which the absence of a market for the shares can damage shareholders in a closely held corporation). Additionally, *see* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*,

levels of separation of ownership and control make the internal governance of LLCs appear elective. Another aspect that complicates LLCs' internal governance is that members can waive fiduciary duties toward each other by including the respective clause in their LLC's operating agreement.[106] This fact strengthens the LLC's individualistic aspects, which do not favor weaker members.

2. *The Vulnerability of the Agency Shield and Moral Disengagement*

Manager-managed LLCs are susceptible to agency problems, especially if managers hold no membership interests. Further, if the LLC is manager-managed, the manager's position may become encrusted due to their extended mandate. In the LLC, there are agency-related problems and managers may also adopt an abusive behavior, which ultimately leads to the

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57 VAND. L. REV. 83, 122 (2004) (positing that "[c]orporate directors operate within a pervasive web of accountability mechanisms. A very important set of constraints are provided by competition in a number of markets. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by directors and managers."). It is also interesting to compare how incentives provided to managers of privately held companies differ from the incentives provided to directors or corporate board members of publicly held companies. The bottom line is that the market can provide incentives to managers to exert their duties efficiently. *See* Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making, and Shareholder Wealth*, 7 J. ACCOUNT. ECON. 179 (1985) (providing a theoretical and empirical analysis of the association of golden parachutes (GPs) with managerial decision-making, and shareholder wealth. Their results suggest that the adoption of GPs is associated with a positive security market reaction. Overall, they consider that GPs have a positive effect on the actions of top executives.). For a more critical view, *see* Lucian Bebchuck, Alma Cohen & Charles C. Y. Wang, *Golden Parachutes and the Wealth of Shareholders* 25 J. CORP. FINAN. 140 (2014). The authors' underlying claim is that GPs weaken the market's disciplinary force for corporate control.

[106] *See* UNIF. LTD. LIAB. CO. ACT §105(a)(1) (1997) (last amended 2013) (setting forth that "[e]xcept as otherwise provided in subsections (c) and (d), the operating agreement governs [. . .] relations among the members as members and between the members and the limited liability company."); *see* UNIF. LTD. LIAB. CO. ACT §105(d)(3)(A), (B), (C), (D) which determines the following:

> (3) If not manifestly unreasonable, the operating agreement may:
> (A) alter or eliminate the aspects of the duty of loyalty stated in Section 409(b) and (i);
> (B) identify specific types or categories of activities that do not violate the duty of loyalty;
> (C) alter the duty of care, but may not authorize conduct involving bad faith, willful or intentional misconduct, or knowing violation of the law; and
> (D) alter or eliminate any other fiduciary duty.

"expropriation" of membership interests.

Other problems LLCs face include members' opportunistic behavior, bargaining failures, difficulties in combining actions among members, members and other non-member constituencies such as creditors, members holding-up others, and finally, deadlock situations for which the operating agreements do not always provide efficient responses.[107] These problems are exacerbated by majority rules, the power of controlling or activist members, and the benefit of hindsight of the knowledgeable manager acting opportunistically.

It is often understood that the separation of ownership and control leads to agency problems between shareholders and directors in publicly held corporations. However, agency problems are also likely to happen in LLCs, where the separation between ownership and control is frequently indistinct.[108] Commentators have not always assumed it this way.[109] However, agency problems of a different type do flourish in the LLC. Instead of agency problems between directors and dispersed shareholders as in the publicly held corporation, LLCs experience agency problems between the members in control of the firm and those who are not.

Additionally, there are member-creditor agency problems in the LLC, as LLCs and other closely held corporations are mostly financed by debt and retained earnings. These agency problems are neither evident to a regulator because these business entities are not subject to a global market demand for securities, nor are they or their members bound by mandatory disclosure rules

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[107] R. H. Coase, *The Problem of Social Cost,* 3 J.L. & ECON. 1 (1960).

[108] Comes to mind an anecdotal report that a manager of a closely held corporation gave me while I was writing an earlier draft that led to this article. The closely held corporation had a registered office in the suburbs of New York City and was composed of three members. Some of its shares were transferred to a third-party without the company's or the non-transferring shareholders' consent. The third-party was the brother of the transferor. In addition to being a member, the transferor was the manager. The transferee was an undocumented immigrant and originally from the Dominican Republic. Although this was an un-consented transfer, the transferee was tacitly accepted into the corporation. Over time, conflicts between the majority shareholder and the transferee surfaced. The transferee threatened to take the majority shareholder to court. The transferee accused the majority shareholder of a breach of his duty of loyalty for problems related to the distribution of dividends and interference with employees' strategy in the corporation. In turn, the majority shareholder accused the transferee of keeping information away from the management. They agreed the closely held corporation would pay the transferee $100,000 for him to withdraw. Ultimately, the agency problems and systematic breach of fiduciary duties that plagued the small corporation led to its dissolution and liquidation. The resonance of this story involving a closely held corporation with what happens in LLCs is relevant because both types of business organizations are closely held. *See* Larry E. Ribstein, *The Closely Held Firm: A View from the United States,* 19 MELB. U. L. REV. 950 (1994).

[109] *See* Fama & Jensen, *supra* note 13, at 322 (saying that the combination of decision management and control in few agents in closely held corporations, small partnerships, and proprietorships avoids agency problems between "residual claimants" and decision-makers).

or whistleblower practices.[110]

Agency problems and bargaining failures create disincentives for members to engage in the LLC's management. The distancing of the members from the control of the company is intriguing.[111] It is a common understanding in literature that members are usually part of the management in LLCs.[112] Those who own units in these business entities have part of their wealth linked to the business. Therefore, taking into consideration that these are not liquid investments, participating in the company's management should constitute an incentive for the members to protect their investments.[113]

However, members expect managers to do their job without much supervision. Thus, they grant the managers autonomy, but in the process, become dependent on them to the point that unclear property rights in the units are not sufficient to overcome self-dealing by the management. Hence, without self-motivated investors minding the company's business, managers' effective constraints are small.

C. *The Ownership Piercing Test: An Alternative Mechanism?*

In those situations where members, such as minority members, are in a weaker bargaining position, or where the complexity of the contractual relations is such that creditors of one member are led to think that they will be in a position to capitalize on that member's assets when, in fact, they cannot due to agency problems, bargaining failures, and hold-ups in the company, there should be a mechanism to pierce the ownership veil to protect the interests of the members and their creditors.

On the flip side, ownership piercing will reveal the type of control that is exerted in the company and who exercises that control. In the LLC, it is apparent that this control is not always connected to ownership. Ownership piercing may show that control is materially employed by a manager who runs the company's business, even when the LLC's operating agreement does not designate that manager as a formal manager. In these circumstances, the question is to understand when a manager's actions amount to material

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[110] *See* Easterbrook & Fischel, *supra* note 105, at 301 (noting that even though closely held corporations avoid agency costs of the same dimension of publicly held corporations by rolling managers and investors into one, the fact is that this does not prevent problems of continuity in the management board, opportunistic behavior, and deadlocks from happening. These authors adopt an objective approach to contracts—for them, the company is a nexus of contracts. Therefore, problems as those just mentioned must find an answer in the company's contractual framework to which lawyers significantly contribute by providing mechanisms to overcome the costs of closely held corporations.).

[111] *See* Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1410 (2008) (referring to shareholders' moral disengagement in publicly held corporations). This behavior is not exclusive to this business entity.

[112] *See* Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6 §18-402 (1992).

[113] *See* BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 63 (1997).

participation in the company's business. This inquiry means that it should be possible for courts to ownership pierce. If courts will ownership pierce, I suggest they apply a three-pronged test to unveil the company's real owners: the managers. This test boils down to the following questions and sub-set of questions.

1. Does the *de facto* manager control the company?
   - Are the *de facto* manager's duties defined in contracts other than the operating agreement?
   - Does the *de facto* manager have a proprietary interest in the company's business deriving from contract?
   - Is the *de facto* manager subject to fiduciary duties deriving from contract?
2. Would it lead to inequitable results if the *de facto* manager was not treated as a controller?
3. Given the individual's position in the company, does the business judgment rule apply?

If the court's findings are positive, then ownership piercing's three-pronged test is met, which means the court will shift the burden of proof in the business judgment rule. In other words, once the court engages in ownership piercing to determine the extent of the managers' control of the company and their actual ownership, the managers-defendants are the ones who carry the burden of proving that they did not breach fiduciary duties.

By piercing the ownership veil, courts scrutinize and interfere, if necessary, with the contractual arrangements in the LLC while considering who the beneficial owners are.[114] The courts' consideration of the company's ownership structure and beneficial owners is what distinguishes ownership piercing from other contractual terminology such as "an agreement needs to be reformed because the parties did not act in good faith, or because circumstances have changed."[115] Those arrangements informing the LLC in which courts interfere rest on a specific ownership structure that facilitates an

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[114] *See* PETER LOW & TYMON KIEPE, BENEFICIAL OWNERSHIP IN LAW: DEFINITIONS AND THRESHOLDS 4 (Victor Ponsford ed., Open Ownership 2020) (positing that "what constitutes indirect ownership and control is the main challenge in legal definitions. Control of a corporate vehicle can be exercised in many different ways, including through ownership, contractual, or informal arrangements. Additionally, the ways in which an individual can directly or indirectly control or own a business will depend on the specific legal context in a country, including via its company, inheritance, and tax laws, which can all provide other ways for individuals to derive benefits from a company"). *See also* BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED (2008).

[115] Regarding the principle of good faith in the contractual setting, *see* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith,* 94 HARV. L. REV. 369 (1980); and STEVEN J. BURTON & ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT (1995). *See also* René David, *Frustration of Contract in French Law,* 28 J. COMP. LEGIS. & INT'L L. 11 (1946).

unequal bargaining power advanced by one of the parties to the dispute. The inequality of bargaining power often leads to self-dealing.

By directly interfering in a consensual agreement, ownership piercing runs counter to the objective approach that common-law judges, particularly Delaware judges, usually adopt toward contracts.[116] They are often said to consider that parties can look after themselves. In light of that understanding, courts tend to interpret contracts narrowly. However, by ownership piercing, judges should be able to plumb the operating agreement insofar as there is evidence that a manager is not acting in the interest of the company or its members.

In those circumstances, ownership piercing helps determine if the company's decision- making process is materially in the hands of the designated managers when, according to the operating agreement, it should be in the hands of the members. By piercing the ownership veil, the court will determine if the company's management is being abusively held.

The management issues may indeed fall within the rubric of business judgment for which courts may not be sufficiently knowledgeable. However, I design ownership piercing to penetrate situations where managers' acts are abusive, fraudulent, or destructive of members' rights. Unsettling ownership structures in a manager-managed LLC may be advisable if ownership and control end up inevitably commingling in the hands of managers, and that combination results in fuzzy property rights of the members.

VII. Fiduciary Duties, The Business Judgment Rule, and Ownership Piercing

In *Harron*, the defendant-manager, who was not a formal manager, was accused by the plaintiffs—the Companies—of breaching fiduciary duties and the LLC's operating agreement while serving as a manager because he was self-dealing. The accusations against the defendant stemmed from the plaintiffs' understanding that he was an acting manager of the Companies because he materially participated in the Companies' management.

Besides its literal approach to the statute, the Delaware Court of Chancery did not provide controlling criteria for applying the material-participation test. Thus, one must ask—did the defendant control the decision-making process of the company? If the criterion of control overlay was met, has the manager adequately performed his duties? This question is tricky, considering that operating agreements are incomplete. There may be hidden contracts that also constitute the company's framework, and the law does not establish procedural mechanisms to evaluate the merits of the manager's decisions. Is the material-participation test a question of business judgment? The following sections explain that the material-participation test is, first, a question of ownership piercing. In other words, the material-participation test is a matter of defining actual managerial control and accountability to protect the members' and other stakeholders' interests.

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[116] *See* Fisk Ventures, LLC v. Segal 2008 WL 1961156, at *9 (Del. Ch.), aff'd sub nom., Segal v. Fisk Ventures, LLC, 984 A.2d 124 (Del. 2009).

A. *The Control Overlay*

The Delaware Court of Chancery scrutinized indicia that satisfied the plain language of the DLLCA, Section 18-109(a). Those indicia were that the defendant was the Companies' president and, as such, managed their day-to-day operations. Some of his responsibilities included screening opportunities, negotiating joint venture agreements, coordinating meetings with third parties, analyzing whether to make capital calls, overseeing joint venture staff, interacting with joint venture partners, and monitoring the company's performance.[117]

Harron was perceived as the face of the business, and the Companies used him as a point of contact for any potential investors or business partners. His authority was only limited regarding the acquisition or disposal of real property, borrowing money or providing guarantees, or committing the companies to spending or receiving funds beyond a certain threshold. The Court of Chancery refused to approach the manager's role from the control overlay lens. The Court considered that defining whether a person has occupied a control or decision-making role rested on a weak foundation and authority.

However, determining what is required to qualify as an acting manager is not only a matter of statutory interpretation. That determination has been an issue of material fact.[118] Control of the company's business and the assumption of a decision-making role derives from a sense of ownership and personal stake in the transactions that a manager facilitates. There is a benefit for the manager originating from the LLC's operation or the relevant transactions in which that manager participates. Therefore, even if the manager is not a formal manager, that manager will be involved and still occupy a control or decision-making role if that is advantageous for them.[119]

The task of evaluating the manager's activity can demand that those acts carried out by the manager that are immanent and relevant to the operation

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[117] Metro Storage Int'l LLC v. Harron, C.A. No. 2018–0937–JTL, 2019 Del. Ch. LEXIS 272, at *6-7 (Del. Ch. July 19, 2019).

[118] Some courts have applied a "control overlay" approach to determining material participation, while others have used a statutory plain-language approach. *See* Phillips v. Hove, 2011 Del. Ch. LEXIS 137, at *6–12, *25–26 (Del. Ch. Sep. 22, 2011); PT China LLC v. PT Korea LLC, 2010 Del. Ch. LEXIS 38 (Del. Ch. Feb. 26, 2010); Carlo Vichi v. Koninklijke Philips Electronics. N.V., et al., No. CIV.A. 2578–VCP, 2009 WL 4345724, at *13 (Del. Ch. Dec. 1, 2009); Wakley Ltd. v. Ensotran, LLC, No. CV 12–728–GMS, 2014 WL 1116968, at *4–6 (D. Del. Mar. 18, 2014); Feeley v. NHAOCG, LLC, 2012 WL 966944, at *665–68 (Del. Ch. Mar. 20, 2012); Fisk Ventures, LLC v. Segal, 2008 WL 1961156, at *7–8 (Del. Ch. May 7, 2008).

[119] *See* Carlo Vichi v. Koninklijke Philips Electronics N.V., et al., No. CIV.A. 2578–VCP, 2009 WL 4345724, at *18-19 (Del. Ch. Dec. 1, 2009), where the court found that the defendant did not personally participate materially in the company's management within the meaning of 6 Del. C. §§ 18-109(a) because the plaintiff did not show that the defendant had any ownership "share" in the LLC or a personal stake in the transaction that the manager facilitated.

of the business, but not formally contemplated in the operating agreement, should be brought to light, and realized by the court's decision through ownership piercing. Thus, ownership piercing goes beyond the literal or plain meaning approach that the Delaware Court of Chancery applied to the DLLCA Section 18-109(a) and the objective approach it used while reading the Companies' operating agreements.

B. *Fiduciary Duties*

Relationships between members and managers configure a fiduciary relationship—one that is ultimately based on *fiducia*—trust. In corporate law, the economic analysis of agency costs and the doctrine of incomplete contracts have created the ground for discussing fiduciary duties owed by directors to shareholders.[120] Fiduciary law imposes fiduciary duties on fiduciaries, that is, directors and managers. Those fiduciary duties are traditionally divided into two major categories: the duty of loyalty and the duty of care. Then, there is the duty of good faith, which Delaware courts have maintained as a dimension of the duty of loyalty.[121]

Some corporate law commentators treat fiduciary law as part of contract law, for the most part, based upon their economic analysis of corporate law.[122]

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[120] *See* TAMAR FRANKEL, *Fiduciary Duties*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 127 (Peter Newman ed.1998) (describing the features of fiduciary relationships); TAMAR T. FRANKEL, FIDUCIARY LAW (2010) (describing the legal duties of fiduciaries, and providing analysis of fundamental issues regarding fiduciary law); FRANK E. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 92 (1991) (explaining that fiduciary duties are needed to overcome the high costs of direct monitoring of managers by shareholders. Monitoring is necessary because contracts are naturally incomplete. According to their "nexus of contract" approach, the corporation is also incomplete. Hence, as they put it, "the fiduciary principle is a rule for completing incomplete bargains in a contractual structure."). *See also* Henry N. Butler & Larry E. Ribstein, 65 *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, WASH. L. REV. 1, 28 (1990) (viewing fiduciary duties as part of the corporation's contractual theory. Hence, shareholders should feel free to alter these duties and remedies by agreement. In their words, "[t]he role of fiduciary duties must be understood in the context of contracting problems in long-term contracts."); ROBERT C. CLARK, *Agency Costs versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (John W. Pratt & Richard J. Zeckhauser eds. 1985).

[121] The principle of good faith is consecrated in the Civil Codes of Portugal, Spain, Italy, and France. Traditionally, it has not gained much ground in United Kingdom law, but it is possible to find court decisions referencing this principle. Delaware courts have long recognized good faith in the United States as one of the directors' fiduciary duties toward shareholders. *See* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence* 55 DUKE L. J. 1, 3 (2005); Melvin A. Eisenberg, *The Duty of Good Faith in American Corporate Law*, 3 ECFR 1 (2006); Benjamin Means, *A Contractual Approach to Shareholder Oppression Law* 79 FORDHAM L. REV. 1161 (2011); Christopher M. Bruner, *Good Faith in Revlon-Land*, 55 N.Y.L. SCH. L. REV. 581 (2011).

[122] *See* EASTERBROOK & FISCHEL, *supra* note 120; Butler & Ribstein, *supra* note

The economic analysis of the corporate entity views consensual agreements such as the company's operating agreement as purely contractual.[123] Despite the contractual approach pursued by those scholars, American courts have put out a solid amount of case law on fiduciary duties as part of a separate field of law.[124]

There are two dimensions from which the Delaware Court of Chancery could have assessed the defendant's participation in managing the companies' businesses. The Court could have evaluated the defendant's involvement through the dimension of fiduciary law as an autonomous field of law, which would have determined examining the individual requirements of the duties of care, loyalty, and good faith.

Alternatively, the Court could have assessed the manager's actions through the contractual dimension involving the relationship between the Companies and the defendant from where the duties of care, loyalty, and good faith derived. It would have been better if the Court had focused on the contractual relationship between the defendant and the Companies to ascertain whether the defendant was an active manager. The contractual relationship between the manager and the Companies is informed by the manager's proprietary interests and the decision-making role he played in the Companies.[125] In other words, Harron's proprietary interests assumed different shapes due to the contracts he was bound to as an acting manager. This unintended contractual consequence is an illustration of legal pleiotropy.

Had the Delaware Court of Chancery followed the latter route, that is, assessed the manager's actions through the contractual dimension from where his fiduciary duties developed, it would have provided a better ground

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120.

[123] *See* EASTERBROOK & FISCHEL, *supra* note 120; Butler & Ribstein, *supra* note 120.

[124] *See e.g.,* Fisk v Segal, C.V. No. 3017 – CC, 2008 Del. Ch. LEXIS 158, at *45 (Del, 7 May 2008); Lerner v. Westreich, No. 603184–2005, 2006 N.Y. Misc. LEXIS, at *4–7 (N.Y. App. Div. 2006); Tzolis v. Wolff, No. 5, 2008 N.Y. LEXIS 226, at *11 (N.Y. 2008). *Also see* Marc I. Steinberg, *To Call a Donkey a Racehorse—The Fiduciary Duty Misnomer in Corporate and Securities Law*, 48 J. CORP. L. 1 (2022) (criticizing the contemporaneous lack of adherence to a rigorous application of fiduciary standards in corporate and securities law). I note that contract law is designed to encompass fiduciary relationships in European civil law countries, particularly Portugal, France, Italy, and Spain. In these jurisdictions, fiduciary law is not an autonomous field. Except for the contract of mandate, the contract for the benefit of a third party, *la fiducie* in France, and long-term contracts, such as employment contracts or distribution contracts, which are likely to trigger fiduciary duties, the concept of beneficial ownership in Anglo-American systems is not accepted in the same terms in European jurisdictions. Furthermore, courts in civil law systems are more likely to interfere with the consensual agreement and interpret the relevant contractual duties as opposed to the objective contractual approach adopted by courts in common-law systems, especially in the United Kingdom and the United States.

[125] *See* Means, *supra* note 121 (suggesting that contract theory provides a more coherent framework than fiduciary law for explaining the shareholder relationship).

than a literal or plain meaning approach to statutory interpretation. Then, the Court would have been better positioned to assess the level of accountability of the manager who was not formally nominated as such in the operating agreement and was, for that reason, an acting manager. Assessing the acting manager's accountability is critical toward the members' interests and other stakeholders' interests, including the Companies' long-term and short-term interests.

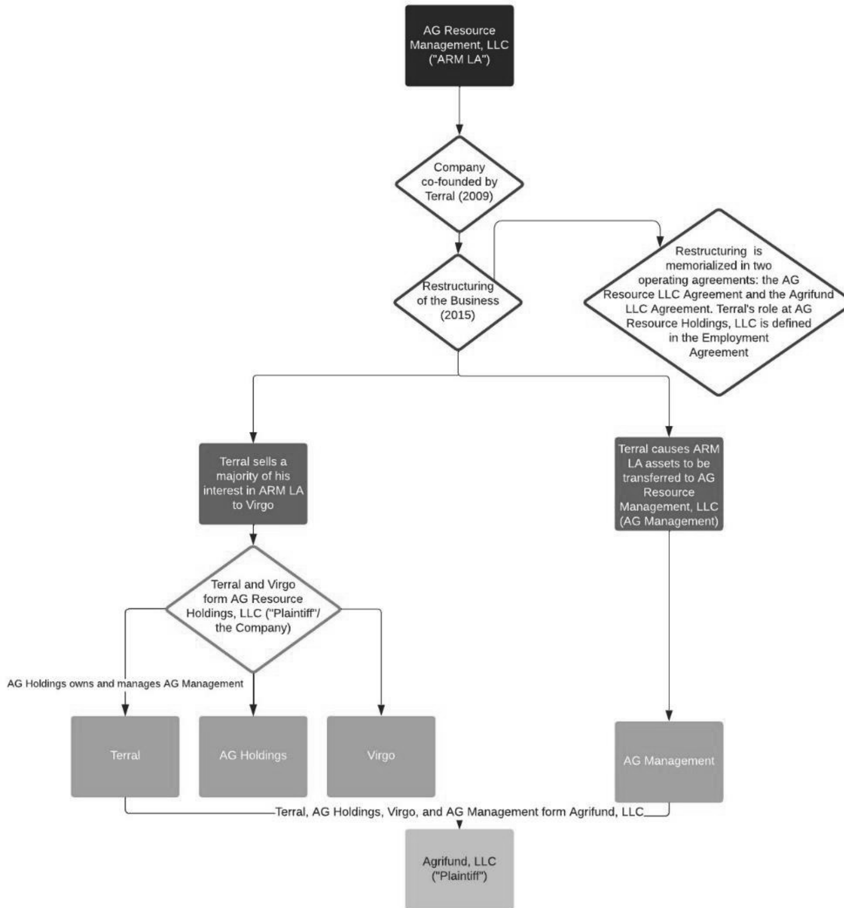
Harron is not the only case where the Delaware Court of Chancery had to parse out issues related to a manager's status and the scope of that manager's fiduciary duties. In *AG Resource Holdings, LLC, et al. v. Thomas Bradford Terral* ("*Terral*"), the Delaware Court of Chancery had to decide whether Terral violated his fiduciary duty of good faith as a manager while simultaneously being an owner of the LLC that filed the complaint ("the Company").[126]

Terral's ongoing role in the Company was governed by two LLC agreements and an employment agreement. The LLC agreements contained a "good faith" clause, "requiring the Company's managers, including Terral, to act "in good faith and within the scope of [the manager's] authority."[127] Additionally, "the LLC agreements set forth non-competition covenants preventing members from competing with the Company or engaging in business with competitors of the Company."[128]

The employment agreement laid out its own restrictive covenants, including a non-competition provision, a non-solicitation provision, a non-disparagement provision, a non-interference provision, and an agreement not to share confidential information.[129] Ultimately, the LLC agreements contained both a Delaware choice of law and a Delaware choice of forum provision. At the same time, the employment agreement had a Delaware choice of law provision but no choice of forum provision. Figure 1 illustrates the ownership structure and contractual framework the Delaware Court of Chancery had to scrutinize in *Terral*.

[126] AG Resource Holdings, LLC et al. v. Terral, No. 2020–0850–JRS, 2021 Del. Ch. LEXIS 24, at *1–3 (Del. Ch. Feb. 10, 2021).
[127] *Id.* at *3–4.
[128] *Id.* at *4.
[129] *Id.* at *4.

Figure 1. Terral: Ownership and Governance Diagram



My focus deviates from the procedural and choice of law matters. I am mainly concerned with the Company's claims regarding Terral's breach of the LLC and employment agreements. "[T]he Company terminated Terral from all positions within the Company after discovering he was secretly planning either to compete directly with the Company or otherwise "steal Plaintiffs' business." The termination was "for cause,"[130] which meant that the plaintiffs had the right to repurchase from Terral certain units under various equity agreements between Terral and the Company.[131]

In this case, Terral's authority as a manager was intertwined with that of owner. Terral wore two hats, which made it challenging to sort out his level of accountability. Applying the ownership piercing test determines the following questions to be asked. Did Terral use his manager position to

[130] *Id.* at *4–5.
[131] *Id.* at *5.

control the company as an owner? In his capacity as manager, did Terral have a proprietary interest in the company's business deriving from contracts? Was Terral subject to fiduciary duties deriving from contracts? Would not treating Terral as a controller while assessing his conduct and dissemination of information to third parties lead to inequitable results? Given Terral's position in the company, did the business judgment rule apply?

The responses to these questions are all positive. Hence, in situations like these, courts should ownership pierce and shift the burden of proof in the business judgment rule to hold the manager-owner-defendant to a higher standard if the manager breaches the contracts applicable to them by manipulating their position in the company.[132]

C. *The Business Judgment Rule and the Shift of the Burden of Proof*

Fiduciary duties are the reason the business judgment rule exists.[133] The business judgment rule works as the obverse of fiduciary duties to protect directors or managers against personal liability while in office. The business judgment rule is an old common-law principle of corporate governance created in the late nineteenth and early twenty-first century.[134] The American Law Institute's Principles of Corporate Governance § 4.01 sets forth the following.

> (c) A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:
>
> (1) is not interested [§1.23] in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation.[135]

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[132] *See also* Focus Financial Partners, LLC v. Holsopple, 241 A.3d 784, 811 (Del. Ch. 2020), where the question of status as an owner or employee is equally significant. Ownership piercing can be a mechanism that helps courts sort situations like this out.

[133] *See* BERLE & MEANS, *supra* note 69, at 296 (claiming that "[t]he management of an enterprise is, by nature, a task which courts cannot assume; and the various devices by which management and control have absorbed a portion of the profit-stream have been so intimately related to the business conduct of an enterprise, that the courts seem to have felt not only reluctant to interfere, but positively afraid to do so.").

[134] Although the business judgment rule is rooted in the United States' corporate law, other European countries have adopted it. In Germany, it was largely adopted by the *Bundesgerichtshof* (BGH) in the II ZR 175/95 "ARAG/Garmenbeck" case. It was also established in Section 93 of the Aktiengesetz (AktG).

[135] PRINCIPLES OF CORP. GOVERNANCE § 4.01 (AM. L. INST. 1994).

The business judgment rule has traditionally been construed by jurisprudence and doctrine as appropriate for handling situations where conflicts between directors or managers and shareholders or members demand careful review because the cases are not clear-cut.[136]

The typical *rationale* for the business judgment rule is as follows: courts should be competent to decide, courts should not substitute the decisions taken by experienced business executives whose knowledge makes them more equipped than courts to decide on business matters, and courts should adopt a standard of judicial review that enables them to avoid the impact of hindsight bias on their judgments regarding the risks taken by directors and managers for the company's business.[137] Just as importantly, managers bargain for non-reviewability of their decisions and often would not be willing to serve if their business decisions were second guessable and were constantly second-guessed. As Kenneth Arrow posited, "the power to review is the power to decide."[138]

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[136] *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 259 (1999) (criticizing the principal-agent model by saying that "the principal-agent model assumes that it is clear who the principal is, and who the agent is in the particular relationship or transaction under study. Yet many of the most important relationships inside corporations may be more ambiguous, in the sense that both parties may be contributing productive inputs, and neither may have authority over the other. In fact . . . this fundamental ambiguity underlies the basic structure of corporate law and provides the foundation for a more useful theory of public corporations.").
The same applies to the LLC due to its contractual nature. *See* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgement Rule*, 60 BUS. LAW 439, 440 (2005) (arguing that the business judgment rule does not and should not apply to corporate officers in the same broad manner in which the rule applies to directors.); Fred W. Triem, *Judicial Schizophrenia in Corporate Law: Confusing the Standard of Care with the Business Judgment Rule*, 24 ALASKA L. REV. 23, 24 (2007) (explaining the difference between the concepts of the standard of directors' care and standard of directors' liability and their different treatment.); Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP. L. 405 (2013) (arguing that fiduciary duties should be made more prominent and that the business judgment rule should be deemphasized when it comes to analyzing officer and controlling shareholder fiduciary duties.); Ann M. Scarlett, *A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation*, 57 U. KAN. L. REV. 39 (2008) (arguing that since the business judgment rule is used to balance authority and accountability, courts need a clear framework for applying the business judgment rule that achieves the necessary balancing point.); and Bainbridge *supra* note 105 (arguing that the business judgment rule can be understood as a doctrine of abstention, under which courts refrain from reviewing board decisions unless specific conditions for review of these decisions are met).

[137] *See* Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 574 (1998) (suggesting that the business judgment rule is an example of a situation in which courts do not apply a liability rule when a particular course of action could have been in hindsight considered negligent).

[138] *See* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974).

The link between the business judgment rule and ownership piercing is as follows—when the managers cannot adequately exercise their fiduciary duties, and their judgment discernment is thereby curtailed, the courts should interfere with the contractual framework from which the managers' duties derive.[139] The presumption of the business judgment rule can (leaving aside bad faith and known violations of the law) be rebutted by proving that the managers did not act on an informed basis (in which case there is a violation of the duty of care), or that managers have a self-interest in the transaction (in which case there is a breach of the duty of loyalty). Ownership piercing, which implies the court's qualified evaluative reasoning, should occur when it is shown that the managers violated their fiduciary duties because they acted in a self-interested manner, as *Harron* illustrates.

One could object to this idea by saying that some discretionary evaluative reasoning will apply at some level in most cases. Nevertheless, the burden of proof to show that their conduct did not breach the duties of care and loyalty would rest entirely on the managers, as it happens in self-dealing cases when the plaintiff has succeeded in rebutting the presumption of the business judgment rule.[140] Ultimately, ownership piercing shifts the burden of proof in the application of the business judgment rule. This bold statement calls for further specification.

Members and other stakeholders share an expectation that managers will act in an informed and fair manner. In the epigraph of this article, Plato's advice is "[t]he wisest of you men is he who has realized, like Socrates, that in respect of wisdom, he is really worthless."[141] This advice counts for little if managers cannot provide convincing evidence that they have done everything possible to keep themselves, the company, and members informed. Nonetheless, the burden of proof regarding the meeting of the business judgment rule elements generally rests on the plaintiff, not on the defendant-manager. This is in line with the general principles of civil procedure, which hold that the responsibility for meeting the elements of a claim lies with the claimant.

If plaintiffs provide evidence that managers breached fiduciary duties because managers were subject to a conflict of interests deriving from contract, ownership piercing, or the court's evaluative reasoning should induce a shift of the burden of proof in the application of the business judgment rule. Then, managers would have to show a lack of bad faith or the

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[139] This contractual framework is composed of the operating agreement, but may also include other contracts of which the operating agreement is a part of as an exhibit, for instance.

[140] *See* PRINCIPLES OF CORP. GOVERNANCE §4.01(D) (AM. L. INST. 1994) (providing that "a person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care, including the inapplicability of the provisions as to the fulfillment of duty under Subsection (b) or (c), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation").

[141] *See* PLATO, *Socrates' Defense (Apology), in* THE COLLECTED DIALOGUES OF PLATO INCLUDING THE LETTERS 9 (Edith Hamilton & Huntington Cairns eds., 2005).

absence of a miscarriage of the duties of care and loyalty regarding the protection of the company's interests, its members, and other stakeholders. In addition, managers would have to show the "entire fairness" of a transaction. If they cannot do so, the business judgment rule or courts' review, according to objective standards established by law and case law, will not hold to their benefit.

D. *Ownership Piercing*

When applied to the LLC, ownership piercing overcomes the ambiguity of the relationships between the company constituencies, particularly between managers and members. The notion of ownership piercing yields a qualified degree of court intervention for evaluative reasoning. This approach represents a challenge to judicial systems and courts that would be called upon to intervene in situations where the principle of freedom of contract has traditionally kept them at arm's length. In cases like *Harron* and *Terral,* courts should examine what market participants (i.e., managers and members of the company) are doing empirically, including designing fiduciary duties.

Still, a breach of fiduciary duties is not the only circumstance in which courts should interfere with consensual agreements and practice the substance over form principle, as mentioned earlier. Courts should be free to ownership pierce when there are problems of interpretation of the contractual setting, when there is a breach of formalities foreseen in the operating agreement or other contracts, and when the managers' responsibilities suggest substantial ownership of the company. Specifically, courts should ownership pierce when:

1. Managers indirectly hinder members' exercise of property rights, and a clear definition of the members' property rights is needed to establish the foundations for efficient bargaining.
2. Despite having the right to participate in the company's decision-making process, members become dependent on the managers to the point that the property rights members hold in their units are unclear, and they lose the ability to overcome poorly managed decisions.
3. Members cannot comply with their obligations *vis-à-vis* third parties (e.g., creditors) due to agency problems, bargaining failures, and hold-ups in the company.[142]
4. Managers act as trustees of third parties, which hinders the members' exercise of property rights in

[142] I am not questioning the principle of limited liability or the idea of "asset partitioning." In the text, I refer to situations where members of these companies are prevented from capitalizing on their investment, which can jeopardize third parties' legitimate expectations.

the company.[143]

5. The control over the decision-making process is manipulated by managers who act in a self-interested manner and, therefore, hinder the business judgment rule's advantages.

Ownership piercing is a mechanism that I functionally derive from legal pleiotropy. Because the company's contractual framework controls multiple ownership expressions in the LLC, ownership piercing allows the courts to understand in more detail those controlling contractual features and their unintended impact on the company's governance. Therefore, the taxonomy of the situations above is illustrative. Depending on the dynamic of the operating agreement, there may be other circumstances where courts may be called to ownership pierce to understand the company's ownership structure and how it affects the company's governance and vice versa.

VIII. WHAT OWNERSHIP PIERCING IS NOT

A. *The Operation or Management Test Under Reves v. Ernst & Young*

In 1970, Congress passed the Racketeer Influenced and Corrupt Organizations Act (RICO).[144] RICO is a criminal and civil statute drafted by Congress to combat criminal organizations.[145] This statute sets forth an "operations or management" test under section 1962(c). The specific language of section 1962(c) provides:

> It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.[146]

What does it mean to "conduct or participate, directly or indirectly, in the

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[143] In case of conflict, ownership piercing will allow the court to understand who effectively holds power in the company—the grantor of the trust, the trustee, the beneficiary of the trust, or the company's members?

[144] Racketeer Influenced and Corrupt Organizations 18 U.S.C. §§ 1961-1968 (1970).

[145] See Michael Levi Thomas, Note, *How Does One Operate or Manage an Enterprise? Insights from Boyle v. United States*, 87 N.Y.U. L. REV. 284 (2012); Benjamin Levin, *Blue-Collar Crime: Conspiracy, Organized Labor, and the Anti-Union Civil RICO Claim*, 75 ALB. L. REV. 559 (2011/2012); John K. Cornwell, *RICO Run Amok*, 71 SMU L. REV. 1017 (2018).

[146] For an open access to the statute, *see* https://www.law.cornell.edu/uscode/text/18/part-I/chapter-96 [https://perma.cc/9HUS-UAA8] (last visited Feb. 21, 2023).

conduct of such enterprise's affairs?" Up until 1993, when SCOTUS delivered *Reves v. Ernst & Young* ("*Reves*"),[147] the Federal Circuit Courts yielded very different interpretations of Section 1962(c). In 1993, SCOTUS resolved that inconsistency when it delivered *Reves*. SCOTUS has interpreted the expression "to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs" of Section 1962(c) to mean that a defendant must "operate or manage" the enterprise's affairs in some capacity to be liable under that provision.[148] Notably, the Court stated:

> Once we understand the word "conduct" to require some degree of direction and the word "participate" to require some part in that direction, the meaning of § 1962(c) comes into focus. In order to "participate, directly or indirectly, in the conduct of such enterprise's affairs," one must have some part in directing those affairs. Of course, the word "participate" makes clear that RICO liability is not limited to those with primary responsibility for the enterprise's affairs, just as the phrase "directly or indirectly" makes clear that RICO liability is not limited to those with a formal position in the enterprise, but *some* part in directing the enterprise's affairs is required. The "operation or management" test expresses this requirement in a formulation that is easy to apply.[149] [footnote omitted].

SCOTUS maintained that:

> An enterprise is "operated" not just by upper management but also by lower rung participants in the enterprise who are under the direction of upper management. An enterprise also might be "operated" or "managed" by others "associated with" the enterprise who exert *control* over it as, for example, by bribery.[150] [footnotes omitted, and emphasis added].

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The Court's position in *Reves* was that RICO liability was not limited to those with a formal position in the enterprise. That understanding is in line with the Delaware Court of Chancery's analysis of the DLLCA's structure and the definition of "acting manager" in *Harron*.

The standard set forth by SCOTUS in *Reves* remains the standard today.[151] Thus, currently, the "operation or management" test means that for a defendant to be subject to RICO under section 1962(c) they must "operate or manage" the RICO enterprise's affairs, to some degree, whether it be

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[147] Reves v. Ernst & Young, 507 U.S. 170 (1993).
[148] *Id.* at 179.
[149] *Id.* at 179.
[150] *Id.* at 184.
[151] *See* Boyle v. United States, 556 U.S. 938 (2009).

indirectly or directly.[152]

The burden of proving that the enterprise is being operated or managed to some degree lies with the claimants. However, in applying the operation or management test under RICO, courts do not hold the flexibility to ownership pierce and shift the burden of proof.[153] That would be problematic considering the substantive canons of interpretation of criminal statutes, particularly the rule of lenity, which determines that criminal law be interpreted strictly. In the words of Chief Justice Marshall in *United States v. Wiltberger*:

> The rule that penal laws are to be construed strictly is perhaps not much less old than construction itself. It is founded on the tenderness of the law for the rights of individuals; and on the plain principle that the power of punishment is vested in the legislative, not in the judicial department. It is the legislature, not the Court, which is to define a crime, and ordain its punishment.[154]

B. *The Parent Company's Liability for Its Affiliate's Torts Under U.S. v. Bestfoods*

In *U.S. v. Bestfoods* ("*Bestfoods*"),[155] SCOTUS applied fundamental principles of statutory construction to determine whether a parent corporation that actively participated in and exercised control over the operations of a subsidiary might, automatically, be held liable under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA)[156] Section 107(a)(2) as an operator of a polluting facility owned or operated by the subsidiary.[157] Section 107(a)(2) allows a lawsuit against "any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of."[158]

What does it mean to "own" or "operate" a facility within the meaning of Section 107(a)(2)? SCOTUS did not find a direct answer to this question in CERCLA since it considered the statute to be silent regarding the liability implications of corporate ownership.[159]

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[152] Reves v. Ernst & Young, 507 U.S. 170, 179 (1993).
[153] *See* Part VI, C. for the explanation of the ownership piercing test, which determines the shift of the burden of proof in the application of the business judgment rule.
[154] *See* United States v. Wiltberger, 18 U.S. 76, 95 (1820) as cited in EDGAR BODENHEIMER, JOHN B. OAKLEY & JEAN C. LOVE, AN INTRODUCTION TO THE ANGLO-AMERICAN LEGAL SYSTEM: READINGS AND CASES 204 (4th ed. 2004).
[155] *See* United States v. Bestfoods, 524 U.S. 51 (1998).
[156] *See* Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601-9607 (1980).
[157] United States v. Bestfoods, 524 U.S. 51, 55 (1998).
[158] *See* Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. § 9607(a)(2) (1980).
[159] *See* Peter S. Menell, *Liability of Parent Corporations for Hazardous Waste*

Thus, the Court found the answer in common law or court decisions that consecrated general principles of corporate law. One of those principles is that "a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries."[160] The other principle "applicable to the parent-subsidiary relationship as well as generally, [is] that the corporate veil may be pierced and the shareholder held liable for the corporation's conduct when, *inter alia*, the corporate form would otherwise be misused to accomplish certain wrongful purposes, most notably fraud, on the shareholder's behalf."[161]

In *Bestfoods,* as in *Harron,* the Court clarified the meaning of corporate ownership, control, and the implications of its exercise. In *Bestfoods,* the Court applied corporate law principles to determine a corporate parent's liability. Additionally, the Court used a plain meaning approach to Section 107(a)(2) to define what it means to operate a "polluting facility". In *Bestfoods*, SCOTUS held the following:

> when (but only when) the corporate veil may be pierced, a parent corporation may be charged with derivative CERCLA liability for its subsidiary's actions;[162] (2) a participation-and-control test looking to the parent [corporation]'s supervision over subsidiary, especially one that assumes that dual officers always act on behalf of the parent, cannot be used to identify operation of a facility resulting in direct parental liability [under CERCLA];[163] and (3) direct parental liability under CERCLA's operator provision is not limited to a corporate parent's sole or joint venture operation [with a subsidiary] . . . .[164] The ordinary meaning of the word "operate" in the organizational sense is not limited to those two parental actions, but extends also to situations in which, *e.g.*, joint officers or directors conduct the affairs of the facility on behalf of the parent, or agents of the parent with no position in the subsidiary manage or direct activities at the subsidiary's facility. Norms of corporate behavior (undisturbed by any CERCLA provision) are crucial reference points, both for determining whether a dual officer or director has served the parent in conducting operations at the facility, and for distinguishing a parental officer's oversight of a subsidiary from his control over the operation of the subsidiary's facility. [165]

Pursuant to *Bestfoods,* the parent corporation might be subject to liability

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Cleanup and Damages, 99 HARV. LAW REV. 986 (1986).

[160] United States v. Bestfoods, 524 U.S. 51, 52 (1998).

[161] *Id.* at 52.

[162] *Id.* at 51–52.

[163] *Id.* at 70–71.

[164] *Id.* at 53.

[165] *Id.* at 53.

on two different theories: (1) direct liability for the parent corporation's operation of the subsidiary's facility, or (2) derivative liability when the corporation's veil can be pierced.[166]

Regarding the direct liability of a corporation that acts as "operator," the Court noted that the operator's liability under CERCLA must be determined based on the relationship between the parent corporation and the subsidiary's facility. The operator must direct, manage or conduct the facility's affairs specifically related to pollution. According to the Court:

> Under the plain language of the statute, any person who operates a polluting facility is directly liable for the costs of cleaning up the pollution. See 42 U.S.C. § 9607(a)(2). This is so regardless of whether that person is the facility's owner, the owner's parent corporation or business partner, or even a saboteur who sneaks into the facility at night to discharge its poisons out of malice. If any such act of operating a corporate subsidiary's facility is done on behalf of a parent corporation, the existence of the parent-subsidiary relationship under state corporate law is simply irrelevant to the issue of direct liability.[167]

Despite the determination of direct liability, the Court emphasized that well-established principles of limited liability offered by the corporate form would not be abrogated without express direction from Congress.[168] With respect to derivative liability, the Court reasoned once again that nothing in CERCLA purports to reject the "bedrock principle" that a parent corporation is not liable for the acts of its subsidiaries.[169]

In the words of the Court, "it is hornbook law that "the exercise of the 'control' which stock ownership gives to the stockholders . . . will not create liability beyond the assets of the subsidiary."[170] Thus, the parent corporation can only be liable through corporate veil-piercing, unless the requirements for direct liability are met.[171]

In addition to pointing out that a parent corporation may be found liable either under the direct liability or derivative liability theories, SCOTUS examined the word "operate" as used in CERCLA to determine what level of

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[166] *See* Doan, *supra* note 14, at 259–260; Gwynne Skinner, *Rethinking Limited Liability of Parent Corporations for Foreign Subsidiaries' Violations of International Human Rights Law*, 72 WASH. & LEE L. REV. 1769, 1797 (2015).

[167] *See* United States v. Bestfoods, 524 U.S. 51, 65 (1998).

[168] *Id.* at 62. *See also* Menell, *supra* note 159, at 987 (adopting a differing position and favoring the imposition of liability on parent corporations of insolvent responsible parties. He posits, "[t]he possibility that courts might extend this rule [of limited liability] to enable parent corporations of responsible parties to escape CERCLA liability undermines the purposes of the Act."). Regarding the concept of limited liability, *see* BAINBRIDGE & HENDERSON, *supra* note 81.

[169] *See* United States v. Bestfoods, 524 U.S. 51, 62-64 (1998)

[170] *Id.* at 61–62.

[171] *Id.* at 61–64. *See also* Catherine Ann Hilbert, *United States v. Bestfoods: Parent Corporation Liability Under CERCLA,* 24 DEL J. CORP L. 919 (1999).

involvement with "operations" was necessary for the parent corporation to become directly liable.[172] According to SCOTUS, some level of "direct" operations of the subsidiary by the parent corporation is necessary for "direct" liability.[173] The Court defined an operator as follows:

> [U]nder CERCLA, an operator is simply someone who directs the workings of, manages, or conducts the affairs of a facility. To sharpen the definition for purposes of CERCLA's concern with environmental contamination, an operator must manage, direct, or conduct operations specifically related to pollution, that is, operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations.[174]

To substantiate the concept of "operator" and the verb "to operate," SCOTUS quoted the United States Court of Appeals for the Sixth Circuit and provided the examples advanced by that Court to describe activities that would be sufficient to find direct liability of a parent corporation as an operator of a polluting *facility*. The Court of Appeals said that "when the parent operates the facility in the stead of its subsidiary or alongside the subsidiary in some sort of a joint venture," it could amount to direct liability of the parent corporation as an operator of a facility owned by its subsidiary.[175]

SCOTUS identified other examples. It considered that there would be direct liability:

> [W]hen we observed that a dual officer or director might depart so far from the norms of parental influence exercised through dual officeholding as to serve the parent, even when ostensibly acting on behalf of the subsidiary in operating the facility . . . . Yet another possibility, suggested by the facts of this case, is that an agent of the parent with no hat to wear but the parent's hat might manage or direct activities at the facility.[176]

Regarding direct liability, the bottom line is that a parent corporation may be held directly liable for its own actions when it actually operates the subsidiary's facility itself.[177] However, just what it means for the parent corporation to "actually" operate the facility is unclear.

The Supreme Court rejected the "actual control" test of parental

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[172] *See* United States v. Bestfoods, 524 U.S. 51, 65-67 (1998).
[173] *Id.* at 66.
[174] *Id.* at 66–67.
[175] *Id.* at 71.
[176] *Id.* at 71.
[177] *Id.* at 71 (SCOTUS posits that the "acts of direct operation that give rise to parental liability must necessarily be distinguished from the interference that stems from the normal relationship between parent and subsidiary").

operation when several lower courts had employed this test to determine whether the parent corporation "actually operated the business of its subsidiary."[178] The *Bestfoods* District Court, in a decision that was later overruled, applied the actual control test, and considered that:

> [O]perator liability may attach to a parent corporation both indirectly, when the corporate veil can be pierced under state law, and directly, when the parent has exerted power or influence over its subsidiary by actively participating in, and exercising control over, the subsidiary's business during a period of hazardous waste disposal.[179]

SCOTUS rejected the District Court's application of the "actual control" test of whether the parent "actually operated the business of its subsidiary" because it would inevitably intertwine direct and indirect liability.[180] Possibly SCOTUS understood that the test would lead to an erosion of the principle that the parent corporation is not generally liable for its subsidiary's torts and to the misconception of the veil piercing doctrine. SCOTUS emphasized that the analysis of a parent corporation's direct liability as an operator must derive from the parent's interaction with and operation of the subsidiary's *facility,* not the subsidiary itself.[181]

I suggest that the "actual control" test that SCOTUS rejected in *Bestfoods* to determine the parent corporation's direct liability can be revisited through the lens of ownership piercing. SCOTUS posited that "[c]ontrol of the subsidiary, if extensive enough, gives rise to indirect liability under piercing doctrine, not direct liability under the statutory language."[182] However, the substance over form principle that shapes ownership piercing can also help determine the parent corporation's direct liability. Determining the parent corporation's direct liability through ownership piercing would mean defining who *actually* controls or is in charge of the decision-making process that affects the subsidiary's facility.

IX. CONCLUSION

In this article, I propose a theoretical framework that explains who substantively controls the LLC, especially when a manager is not formally indicated in the LLC's operating agreement and, as such, is found to be self-dealing. Ownership piercing means that the courts engage in a qualified process of evaluative reasoning. Ownership piercing may happen when control rights or management rights in the company amount to ownership

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[178] *See* United States v. Bestfoods, 524 U.S. 51, 67 (1998).
[179] *Id.* at 51.
[180] *Id.* at 67.
[181] *Id.* at 67. (The Court stated that "the test is administered by asking a question about the relationship between the two corporations (an issue going to indirect liability) instead of a question about the parent's interaction with the subsidiary's facility (the source of any direct liability)."
[182] *See* United States v. Bestfoods, 524 U.S. 51, 68 (1998).

rights due to the contractual framework that informs the company. The idea of management rights as ownership rights reflects the concept of *legal pleiotropy*. In other words, ownership may assume different expressions that are controlled by the company's contractual framework.

By ownership piercing, the court unveils the company's real owners, the managers. Piercing shifts the burden of proof in the application of the business judgment rule. As a result, whenever courts engage in that process of evaluative reasoning, managers' responsibility is to prove that they have abided by the fiduciary duties that the law and particularly the operating agreement impose on them.

In *Harron*, the Delaware Court of Chancery should have taken a step beyond the literal approach to statutory interpretation. It should have analyzed the companies' operating agreements and possibly other hidden contracts to assess the manager-defendant's proprietary interests effectively. Perhaps, those proprietary interests could have more reliably spelled out his role as an active manager.

I ask the following questions—what does it mean to participate materially in the management of the company? In other words, how does one meet the material-participation test that Section 18-109(a)(ii) of the DLLCA sets forth? To respond to these inquiries, I advance a normative argument for legal policy. Ownership piercing could be implemented either through the legislature or by the courts with the available doctrinal and methodological tools such as teleological interpretation and the comparative method. Countries like Italy, France, and Germany, where courts tend to apply a subjective approach to contracts due to the nature of their civil law, are possible sources from which to borrow.

I am not oblivious to the fact that ownership piercing may raise questions to which more positivist readings of the role of courts call attention. The possible irrationality of courts, the threat to the separation of powers as courts may takeover prerogatives that belong to the legislature, the interference with freedom of contract, and judicial supremacy are some noteworthy examples. However, from a normative perspective, there should be no resistance if we consider the LLC a byproduct of private ordering. Perceiving the LLC as such requires that courts empirically observe market participants before adjudicating and engaging in ownership piercing.