State Law & State Taxation Corner

By Thomas E. Rutledge

Putting the Shepherds and the Magi in the Manger– The Problem of False Isomorphism

Changes over the last 30 years in business entity law present a significant challenge to a judiciary charged to resolve disputes between the constituents to business organizations. Where in prior periods there was largely a binary division between those organizations organized as corporations and those organized as partnerships, each with a distinct organizational statute and a largely distinct body of common law, we are today faced with a multitude of organizational forms spanning a continuum. Still, our judiciary is largely one whose training is rooted in the prior binary paradigm. Further, outside of the atypical courts of Delaware and the various specialized business courts that are of late coming into existence, expertise in business entity law is not something that may often be expected of the judiciary, resulting in opportunity for confusion as to both the underlying substantive law and the frame of reference to be employed.

A number of cases indicate that courts are all too often confused as to the appropriate frame of reference when considering disputes involving limited liability companies, typically attempting to apply principles of corporate law to the issues under consideration. Doing so is a failure based upon the false assumption that it is the corporation that represents the archetype of business organizations, the normative standard against which all other forms are to be measured. For any of a variety of reasons, this assumption is erroneous. Rather, the corporation is but one form of organization, a form that in its present form is the product of over a century of statutory evolution. Other forms including the partnership and the limited liability company (LLC) are equally legitimate products of statutory evolution.

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At the same time, practitioners and the courts need to be aware of accurate similarities between forms and from that recognition build upon the prior learning. Laments that there are no decisions interpreting the statutory language are often based upon a failure of complete investigation. Language adopted from other acts of a state may have been interpreted, and language adopted from uniform and prototype acts likely has been reviewed by a court and has often been released with explanatory commentary.

Isomorphism

Isomorphism exists when two sets or groups have the same structure, notwithstanding that the names and notations for the elements in the sets or groups are different. While isomorphic sets are not identical, what can be properly said about one may be equally said about the other.[1] Isomorphism is in mathematics an important tool for drawing knowledge from one field of inquiry and applying it elsewhere. It is, however, a most pernicious concept in law as the labels we utilize often lack a true equivalent. When we seek to treat one legal construct as isomorphic to another, we typically yield only a flawed (and false) analysis.

False Isomorphism and the Description of the LLC

Unfortunately, an overly simplistic description of the LLC has often led to problems of inappropriate isomorphism with other business organizations. An LLC has been described as "in essence … a hybrid business entity that offers its members limited liability, as if they were shareholders of a corporation, but treats the entity and its members as a partnership for tax purposes."[2] Both aspects of this description are false.

Initially, members in an LLC do not have limited liability "as if they were shareholders of a corporation"; members of an LLC have limited liability because a limited liability company act applicable to that particular organization has afforded the members limited liability.[3] The law of corporations is not the source from which LLC members enjoy limited liability[4]; this author is unaware of an LLC Act that is "linked" to a corporate act for applicable rules generally or for the rule of limited liability in particular.[5] Equally farcical would be the assertion that a "Toyota Prius has four wheels as if it were a Porsche Boxer"; the statement is obviously ridiculous in that it is clear that four wheels is an independent structural determination made for each vehicle that is not dependent upon either as a source. In contrast, it would be a correct statement that "the legislature has afforded the shareholders in a corporation and the members in an LLC, as well as the limited partners in a limited partnership and the beneficial owners in a statutory trust, limited liability from the debts and obligations of the organization."

As to the issue of tax classification, while it is true that many LLCs are taxed as partnerships, many are not. For example, there are innumerable LLCs organized with only a single member; not only are these LLCs not taxed as partnerships, but it is impossible for them to be taxed as partnerships.[6] While an LLC with two or more members will have a default classification for purposes of the Internal Revenue Code as a partnership,[7] that partnership may elect to be taxed as a corporation,[8] from which, assuming the other requirements are satisfied, it may elect to be taxed as a small business corporation.[9] Manifestly, the description of an LLC in terms of corporate limited liability and partnership tax classification is at least misleading.

A business venture may be organized in any of a variety of forms including, but not limited to, the partnership, the limited partnership, the LLC and the corporation. None of these forms is the "standard model" against which the others are to be measured and against which reference is to be made from another form. Rather, the reference needs to be back to the first principle, typically the legislative enactment.

False Isomorphism and Inter-Owner Fiduciary Obligations As a Normative Standard

The corporation and the LLC are not species of partnership to which the law of partnerships may be applied. As is too seldom recognized, by express statutory directive partnership law does not apply to other organizational forms.[10] Second, the corporation and the partnership are vastly dissimilar structures; as recognized by a leading authority in the field, "In theory, the archetypical corporation and partnership occupy opposite ends of the spectrum of legal forms of business."[11] These distinctions are as they should be—different forms of organization are intended to embody different menus of characteristics:

> The selection of the form of business (*i.e.*, sole proprietorship, partnership or corporation) is

> a decision of utmost importance in establishing a business. That decision requires weighing numerous factors including tax laws and the consequences thereof, limitation of personal liability, and spreading the amount of potential risk and profit among one or more principals to determine which form is best for a given individual, group or company. [12]

As to the suggestion that the rights and obligations of owners, whether they be partners, members or shareholders, should be the same (followed then by the suggestion that it is the rules of the partnership paradigm that should control), two titans in the field have observed:

> Proponents of the partnership analogy assume that participants in closely held corporations are knowledgeable enough to incorporate to obtain the benefits of favorable tax treatment or limited liability but ignorant of all other differences between corporate and partnership law.[13]

[T]here are innumerable LLCs organized with only a single member; not only are these LLCs not taxed as partnerships, but it is impossible for them to be taxed as partnerships.

Neither the case law nor the scholarly commentary has demonstrated that participants in corporate ventures desire, at the time they enter into those ventures, an inter-owner fiduciary relationship. While an allegedly wronged minority shareholder may, after the fact, assert they expected such a relationship (and here setting aside the requirement of a prior demonstration of that expectation and its undertaking by the majority), they do so in opposition to a willing acceptance of the corporate structure and all of its distinctions from the partnership form. This position is in opposition to the extensive law properly holding that partnerships and corporations are distinct forms of organization affording the participants therein different rights.[14]

Further, even were it appropriate to treat the partnership and the corporation as closely related, doing so would not compel a conclusion that the inter-partner fiduciary obligations should apply equally among shareholders. The analytic source of fiduciary duties among partners is their mutual agency combined with their unlimited liability.[15] Shareholders, in contrast, are not agents for either the corporation or the other shareholders, and shareholders enjoy limited liability.[16] Aside from both being the ultimate residual beneficiaries of the venture, partners and shareholders have little in common.

Another example of this (invalid) principle is the equivalency of corporate shareholders and LLC members. Famously (or at least in my view, infamously), the Massachusetts courts have held that the shareholders in a Massachusetts close corporation stand in a fiduciary relationship with one another.[17] Recently, and with no examination of the language employed in the Massachusetts LLC Act, it was determined that the members of a Massachusetts LLC stand in a fiduciary relationship with one another.[18] How is it possible to suggest, much less rule, that the members in an LLC must have the same fiduciary duties as do the shareholders in a corporation; on what basis are they in similar positions? Further, section 63 of the Massachusetts LLC Act provides that the operating agreement can limit the member's fiduciary obligations; are we to now assume that the shareholders of a Massachusetts corporation may now, by private ordering, modify their fiduciary exposure to one another?

It is not suggested that cross-reference to the law of different business organizations is always inappropriate; doing so is in fact a valuable exercise when done in the proper manner. For example, the formula employed in the 1994 Prototype Limited Liability Company Act for the standard of loyalty, but for form-specific nomenclature, is identical to that utilized in the Uniform Partnership Act.[19] In consequence, decisions interpreting fiduciary obligations under UPA may be used in applying the Prototype's language. There is nothing particularly "partnership" or "LLC" about the statutory formula, and the use of the same words would indicate that the same outcome is desired. Ergo, the cross-referencing is appropriate.

On the other hand, care must be taken to avoid importing foreign concepts from the law of one organizational form into another. It is highly debatable whether the differential standard of review and relaxed threshold of culpability of the business judgment rule is appropriate in the context of an LLC or partnership, especially in those that have by private agreement defined the fiduciary obliga-

tions.[20] Likewise, the importation of a fairness test as an exception to strict liability for the appropriation of an opportunity belonging to the venture[21] is inappropriate; the "fair to the corporation" defense[22] is a creation of the corporate realm that does not, absent private ordering, translate into that of the partnership or LLC.

Avoiding False Isomorphism–Critical Source Analysis

False isomorphism, the assumption of equivalency, can (and should) be avoided through critical source analysis. In this realm, the sources are the statutes and the cases.

As to cases, critical analysis is crucial as the law of business organizations has, in the last 20-some years, undergone seismic changes. Analysis of cases that fails to examine whether statutory alternations have superseded the decision is incomplete. For example, the (in)famous *Fairway Development* decision on privity of contract and partnership dissolution upon a partner's dissociation[23] has now fallen, at least as to those partnerships organized under RUPA and its direction, that a dissociation does not affect the partnership's dissolution.[24] In *Patmon v. Hobbs*,[25] a "fair to the LLC" defense to the appropriation of an LLC's asset was permitted, with the burden being placed on the complaining member to show the absence of fairness. Absent a careful consideration of the law, this case could be cited for these principles. Important for anyone, and crucial for any practitioner in Kentucky, is the fact that in 2012 the statute was amended to legislatively overrule this decision.[26]

There is a bumper sticker that reads "Don't Believe Everything You Think." This is useful advice; our sources, and here let's focus on statutes, do not necessarily say what we might expect them to say. In *Alliance Associates, L.C. v. Alliance Shippers, Inc.*,[27] the plaintiffs sought to excuse their failure to make a demand prior to bringing a derivative action on the basis of the futility exception. Had the derivative action involved a corporation, they might have prevailed, but this suit was brought on behalf of an LLC.

Plaintiff's complaint does not allege, nor do plaintiffs contend, that the required demand was made of AALC's members. Accordingly, the action was not properly brought with respect to AALC and all claims asserted by AALC were properly dismissed for this reason.

We disagree with plaintiff Litt that he was excused from complying with the demand requirement because it would be futile to expect Satwicz to consent to a lawsuit where she was named as a defendant and wrongdoer. The statute does not provide for an exception for futility. It is well settled that a court may not read into a statue that which is not within the manifest intent of the Legislature as indicated by the statute itself. The authority on which plaintiff Litt relies is distinguishable, because it applies to corporate shareholder derivative actions, not limited liability companies. Accordingly, we affirm the trial court's dismissal of all claims brought by AALC.[28]

The various corporate and LLC acts provide similar, but not identical, rules for any number of circumstances and situations, and the distinctions can be crucial.

The various corporate and LLC acts provide similar, but not identical, rules for any number of circumstances and situations, and the distinctions can be crucial. Assumptions that, for example, members and shareholders have similar rights or that directors and members have similar fiduciary obligations, until informed by careful scrutiny of the statutes and the validly applicable case law, should be treated as at minimum questionable, and better yet as invalid.[29]

False Isomorphism in the Manger

A typical manger scene, whether static or living, will feature a bevy of shepherds, often accompanied by their sheep, and a trio of Magi bearing their gifts. The typical viewer will not realize that the manger scene presented combines scenes from distinct Gospels. The manger itself is mentioned only in Luke[30]; Matthew does not mention it. The shepherds are present only in the Gospel of Luke,[31] while the Magi are present only in Gospel of Matthew.[32] In no gospel do both the shepherds and the Magi appear. The manger scene with both shepherds and Magi reflects a scene that is never presented in

any single Gospel. Rather, the manger scene is a product of false isomorphism, combining in a single presentation elements of what are two distinct and independent stories that are not equivalent to one another. Now the manger scene is not intended as a definitive representation of either doctrine or of the individual Gospels; it is theatre[33] intended to remind people of the reason for the Christmas festivities.[34] Failure to appreciate that treatment leads to the false belief that the shepherds and the Magi are part of the same story.

Conclusion

Corporations, partnerships, limited partnerships, LLCs and the many other forms we have available for structuring business relationships provide standard form formats for allocating rights and obligations. Each does so differently than does each other available format. For that reason, assuming equivalency of treatment, that the various forms are isomorphic, is unjustified absent careful analysis demonstrating, in a particular instance, that it is true.

Endnotes

1 *See generally* Barry Mazur, *Where is One Thing Equal to Some Other Thing?*, published in Proof and Other Dilemmas: Mathematics and Philosophy (ed. B. Gold and R. Simons 2008).

2 *See, e.g., Chapman v. Reg'l Radiology Assocs., PLLC*, 2011 Ky. Ct. App. Unpub. LEXIS 251 (Ky. App. Mar. 25, 2011); *Patmon v. Hobbs*, 280 SW3d 589, 593 (Ky. App. 2009) ("A limited liability company is a hybrid business entity having attributes of both a corporation and a partnership."); *Kipp v. Royal & Sun Alliance Personal Ins. Co.*, 209 FSupp2d 962, 963 (E.D. Wisc. 2002); *Bischoff v. Boar's Head Provisions Co., Inc.* 436 FSupp2d 626, 630 (S.D.N.Y. 2006); *Jordan v. Comm.*, 549 SE2d 621, 622 (Va. Ct. App. 2001). Sadly this impoverished description of the LLC is advanced by federal authorities. *See* Choosing Your Business Structure, http://www.sba.gov/content/limited-liability-company-llc ("A limited liability company is a hybrid type of legal structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership.").

3 *See, e.g.*, Rev. Unif. Ltd. Liab. Co. Act §304, 6B U.L.A. 475 (2008); Revised Prototype Ltd. Liab. Co. Act §304, 67 Bus. Law. 117, 153 (Nov. 2011); Del. Code Ann. tit. 6, §18-303(a); Ky. Rev. Stat. Ann. §275.150(1); Ind. Code §23-18-3-3(a); Va. Code §13.1-1019.

4 *See* Bayless Manning, A Concise Textbook on Legal Capital (2d ed.) 5–6 ("[T]he feature of limited liability … played little or no part in the development of modern corporation law."). Blackstone did not identify limited liability as a characteristic of a corporation. *See* 1 Blackstone Commentaries 475; *see also* William J. Clark, Jr., Handbook of the Law of Private Corporations 16 (2d ed. 1907) (limited liability is "not an essential attribute" of the private corporation); Wesley Newcomb Hohfeld, *Nature of Stockholders' Individual Liability for Corporation Debts*, 9 Colum. L. Rev. 285 (1909).

5 In contrast, under the traditional "linkage" of limited partnership law to that of general partnerships, the rights and duties of the partners generally, and in particular the liability of the general partners (including those limited partners who acted outside their acceptable range and were thereby treated as general partners) was determined by a cross-reference in the limited partnership law to the general partnership law. *See* Unif. Ltd. Part. Act (1914) §9; Rev. Unif. Ltd. Part. Act §403(6), 6B U.L.A. 222 (2008); Unif. Part. Act (1914) §15, 6 (pt. I) U.L.A. 613 (2001); Ky. Rev. Stat. Ann. §362.447; *id.* §362.250(1).

6 Reg. §301.7701-2(c)(1); *id.* §301.7701-3(c).

7 Reg. §301.7701-3(b).

8 Reg. §301.7701-3(b)(3)(i).

9 *See also* Reg. §301.7701-3(c)(1)(v)(C); Thomas E. Rutledge, *S Corp LLCs—Planning Opportunity or Solution in Search of a Problem?*, J. Passthrough Entities, July–Aug. 2012, at 37.

10 *See, e.g.*, Unif. Part. Act §6(2), 6 (pt. II) U.L.A. 393 (2001); Rev. Unif. Part Act §202(b), 6 (pt. I) U.L.A. 92 (2001); Ky. Rev. Stat. Ann. §362.175(2) ("any association formed under any other statute of this state … is not a partnership …."); *id.* §362.1-202(2) ("An association formed under a statute other than this subchapter, a predecessor statute, or a comparable statute of another jurisdiction is not a partnership under this subchapter.").

11 1 Robert B. Thompson, O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members §2.10.

12 *Vinson v. Koerner*, No. 2000-CA-001217-MR, slip op. at 6–7 (Ky. App. Nov. 9, 2001).

13 Frank Easterbrook and Daniel Fischel, *Close Corporations and Agency Costs*, 38 Stan. L. Rev. 271, 297 (1986).

14 *See supra* note 11; *Laine v. Commonwealth*, 151 SW2d 1055, 1058 (Ky. 1941) (holding that a one-third shareholder in a corporation is not treated as a partner and does not have the rights of a partner *vis-à-vis* corporate property); *see also KNC Invs., LLC v Lane's End Stallions, Inc.*, 2011 U.S. Dist. LEXIS 130555 (refusing to apply the provision of Kentucky's Business Corporation Act governing record inspection rights to an unincorporated association: "[N]o justification exists to extend Kentucky law that by its own terms is strictly limited to corporations to non-corporate entities such as the LDK Syndicate.").

15 *See* Ky. Rev. Stat. Ann. §362.190(1) (each partner is an agent of the partnership and each other partner); *id.* §362.220(1); and *id.* §362.1-306(1) (partner liability for partnership debts). Under the Revised Uniform Partnership Act (2006), while each partner is an agent of the partnership, a partner is not an agent of any other partner. Rev. Unif. Part. Act §301(1), 6 (pt. I) U.L.A. 110 (2001); Ky. Rev. Stat. Ann. §362.1-301(1).

16 *See, e.g.*, Va. Code §13.1-644(A); Ind. Code §23-1-26-3; Ky. Rev. Stat. Ann. §271B.6-220 (shareholder limited liability); 1 William Meade Fletcher, Fletcher Cyclopedia of the Law of Corporations §30 ("The mere fact that one is a shareholder or a majority or principal shareholder gives the individual no authority to represent the corporation as its agent in dealing with third persons.") (citations omitted).

17 *See Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 NE2d 505 (Mass. 1975); *Wilkes v. Springside Nursing Home, Inc.*, 353 NE2d 657 (Mass. 1976).

18 *Pearson v. Boylston Cypress*, LLC, No. 2008–2319–BLS1, 2012 Mass. Super. LEXIS 200 ("Shareholders in a close corporation owe one another a fiduciary duty of utmost good faith and fair dealing in the operation of the enterprise …. In the present case, there is no dispute that the parties have a fiduciary duty to each other as shareholder-members of B–C LLC, and to B–C LLC itself.")

19 *See generally* Thomas E. Rutledge & Thomas Earl Geu, *The Analytic Protocol for the Duty of Loyalty Under the Prototype LLC Act*, 63 Ark. L. Rev. 473, 475-77 (2010).

20 *See generally* Thomas E. Rutledge & Elizabeth S. Miller, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations*, 30 Del. J. Corp. L.

ENDNOTES

343 (2005), reprinted in III THE ICFAI J. OF CORP AND SEC. LAW 13 (February 2006).

[21] *See generally supra* note 19.

[22] *See, e.g.*, MBCA §8.61(b)(3); IND. CODE §23-1-35-2(a)(3); and KY. REV. STAT. ANN. §271B.8-310(1)(c).

[23] *Fairway Development Corp. v. Title Insurance Co.*, 621 FSupp 120 (N.D. Ohio 1985).

[24] *See* Rev. Unif. Part. Act §603, comment 1, 6 (part 1) U.L.A. 172 (2001).

[25] 280 SW3d 589 (Ky. App. 2009).

[26] See KY. REV. STAT. ANN. §275.170(3), amended by 2012 KY. ACTS, CH. 81, §106; *see also* Rutledge, *The 2012 Amendments to Kentucky's Business Entity Statutes*, 101 KY. L. J. ONLINE 1 (2012).

[27] *Alliance Associates, L.C. v. Alliance* Shippers, Inc., 2006 Mich. App. LEXIS 1778 (Mich. App. 2006).

[28] 2006 Mich. App. LEXIS 1778, *10 (citations omitted).

[29] No credit is given for lucky guesses; you need to be able to prove your work.

[30] *Luke* 2:7.

[31] *Luke* 2:8–20.

[32] *Matthew* 2:1–7. The "three" Magi is a curious case of false equivalency, although it is itself not a case of false isomorphism. Nowhere in the Gospel of Matthew is it stated that there were three Magi. Rather, in that the listed gifts (gold, frankincense and myrrh) were three (*Matthew* 2:12), by tradition there were three Magi.

[33] Neither the Gospel of Mark nor that of John contains a nativity narrative. The manger scene has its initiation in the 12th Century under the influence of St. Francis of Assisi.

[34] Even early in the 13th Century, Christmas was being commercialized.