Profit-Seeking, Individual Liability, and the Idea of the Firm

Richard A. Booth

University of Maryland

Follow this and additional works at: https://openscholarship.wustl.edu/law_lawreview

Part of the Business Organizations Law Commons

Recommended Citation


This F. Hodge O'Neal Corporate and Securities Law Symposium is brought to you for free and open access by the Law School at Washington University Open Scholarship. It has been accepted for inclusion in Washington University Law Review by an authorized administrator of Washington University Open Scholarship. For more information, please contact digital@wumail.wustl.edu.
PROFIT-SEEKING, INDIVIDUAL LIABILITY, AND THE IDEA OF THE FIRM

RICHARD A. BOOTH

The conventional wisdom is that the boom in limited liability companies (LLCs)—whether viewed in terms of the spread of statutes allowing for them or the rush to form companies under those statutes—is primarily driven by tax considerations, at least if one considers the LLC as an alternative to the corporation. (If one considers the LLC as an alternative to the partnership, then the reason for the popularity of the LLC is no doubt limited liability.) Although as an academic I am obligated to question the conventional wisdom, I have little doubt in this case that it is correct. But the conventional wisdom begs a deeper and logically and historically earlier question: Why is it that the law ever developed a presumption of unlimited liability for participants in profit-seeking ventures? And why is it that the LLC, which offers limited liability in combination with taxation as a partnership, seems to call for an explanation?

One easy answer to this question is historical. In the beginning, there was the partnership. And it seemed only natural that the benefits of participating in profit-seeking should carry the price of liability for firm obligations. The growing need for larger firms to pursue larger enterprises, however, meant that large numbers of passive investors were needed. But passive investors, who had no ability to control risks at the firm level, would not invest if they could be held liable for firm debts beyond their investment. Enter the corporation, which since the late 1800s has allowed participation in profit-seeking with the benefits of limited liability. But there was a catch. The fact that liabilities stopped with the firm suggested

* Professor, University of Maryland School of Law, Baltimore, Maryland; A.B., The University of Michigan; J.D., Yale Law School.


2. See id. (discussing the importance of limited liability to the continued existence of corporations).

3. New Jersey was the first state (in 1896) to make the corporate form available to all businesses without special legislative act. See William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 YALE L.J. 663 (1974). New York had made the corporation freely available (though the capital was not to exceed $100,000) to manufacturing companies in 1811. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 136 (1933).
that the firm really was different from the individual investors who composed it. Bolstering this impression was the fact that income from the corporation might never be distributed to the investors unless the board of directors chose to do so.\(^4\) This is not to say that a partner gets paid his share of the profits as soon as there are any. Indeed, partnership law expressly provides that in the absence of an agreement to the contrary, a partner is not entitled to be paid for his or her efforts on behalf of the partnership.\(^5\) Nevertheless, in a partnership, any partner can dissolve the partnership at any time and by that tactic theoretically force a distribution of partnership profits.\(^6\)

One of the other distinctive benefits of the corporate form is that the corporation is a legal person that may enter into contracts in its own name.\(^7\) Although we tend to ignore this benefit nowadays because it is largely available to partnerships as well, it was no doubt a great convenience at first. In any event, corporations seemed to be quite separate from the investors who owned them, and hence they were a tempting target for taxation at the firm level.\(^8\) Thus, corporations are taxed as a unit because corporations are thought to have an identity of their own. Partnerships are not taxed as units because partnerships are thought to be a mere collection of individual partners.\(^9\) Part of the reason for this—no doubt a major reason—is that gains and losses pass directly through to the partners as a matter of partnership law. So it is not so difficult to see how profit-seeking led to unlimited liability, and how limited liability and the notion of a corporate tax arose.\(^10\)


\(^5\) Unif. Partnership Act § 18 (1914) [hereinafter UPA].

\(^6\) Id. §§ 31(1)(b), 38(1).

\(^7\) See, e.g., RMBCA § 3.02(7) (1984).

\(^8\) As The Beatles put it in their song Taxman:

If you drive a car, I'll tax the street,
If you try to sit, I'll tax your seat,
If you get too cold, I'll tax the heat,
If you take a walk, I'll tax your feet,
'Cause I'm the taxman . . . .

The Beatles, Taxman, on Revolver (Apple 1966).


There is, however, a problem with this story. Although limited liability for corporations is in no real danger, it is increasingly questioned by academic commentators. Indeed, the proposition that unlimited liability should be the rule (at least in the context of claims by involuntary (tort) creditors) has gained adherents in recent years.\(^1\) Although it may at first sound radical, in many ways, the idea is a very conservative one. It is little more than another way of saying that a business should bear its costs—or internalize its externalities.\(^2\) This notion is, of course, one of the central tenets of the law and economics school of thought. Ironically, however, it is precisely the scholars of the law and economics persuasion who have also been most vocal in their support of limited liability.\(^3\)

The thesis here is that the historical explanation for the way things are, accurate as it may be, has lost its force as an argument that things should stay that way. To be specific, (1) the line between profit-seeking and non-profit-seeking activity is no longer as bright as it once may have been; and (2) there is nothing magical about limited liability—that is, it is no longer the definitive characteristic of the corporate form. Thus, the rather sudden emergence and astonishing growth of the LLC should be seen as part of a larger evolutionary trend in business organization law and not just as the tax tactic du jour.

I. THE RELATIONSHIP BETWEEN TAX LAW AND BUSINESS LAW

One of the mysteries about the advent and growth of LLCs is why the IRS allowed it to happen. Why in 1988 did the IRS suddenly announce that LLCs were just fine?\(^4\) The answer, I suspect, is that the IRS came to the realization that limited liability was no longer (or perhaps never was) the big deal everybody made it out to be.

Tax law generally tracks business organization law, and indeed in many cases relies on it for purposes of answering tax questions that are not covered by statute. This pattern is seldom noticed, but it is quite distinctive, especially in connection with the taxation of business organizations.

---


13. To some extent, this debate is a red herring for present purposes because the idea that unlimited liability should be the rule is aimed at all business organizations—or indeed perhaps at all organizations whether or not they are in business or some other line of endeavor. Thus, the proponents of unlimited liability are unlikely to care much about forms of organization.

For example, under section 316\textsuperscript{15} of the Internal Revenue Code (and other related sections), a distribution to a shareholder will not be treated as a dividend unless the corporation has "earnings and profits" which, curiously enough, are nowhere defined in the Code.\textsuperscript{16} In practice, however, earnings and profits have been interpreted to mean something very much like the concept of earned surplus. Earned surplus was the standard measure of dividend-paying capacity under the old Model Business Corporation Act (MBCA) (at least for balance sheet purposes) and continues to be used in many of the Model Act states.\textsuperscript{17} In addition, under section 351\textsuperscript{18} of the Code, which sets forth the rules for tax-free contribution of appreciated property to a new or going corporation, the corporation is prohibited from including in the group of property contributors (for purposes of determining control) those who have contributed only services, a restriction that makes little sense but is parallel to the traditional corporate law rule against issuing stock in exchange for a promise of future services.\textsuperscript{19} (It bears noting that both of these corporate law rules have recently fallen under the axe of the 1984 revisions to the MBCA.\textsuperscript{20} Nevertheless, they are still in the tax code.)

The influence of corporation law may also be seen in the litigation of tax issues. In one leading case, for example, the IRS argued that a note issued in connection with the repurchase by a corporation of its own stock could not be regarded as a note for tax purposes because the corporation did not have enough balance sheet surplus at the time the note was issued to cover its entire principal amount. The court held otherwise, on the argument that the corporation could validly obligate itself to make periodic payments that would be subject to the balance sheet test as each payment came due.\textsuperscript{21}

IRS regulations affirmatively deny that "local law" matters when it comes to classifying an organization as a corporation or a partnership for tax purposes.\textsuperscript{22} And to be sure, the IRS is quick to challenge organizations that claim to be one but behave too much like the other. Moreover, the IRS often wins.\textsuperscript{23} But the influence of local law is undeniable, and its interac-

\begin{itemize}
  \item \textsuperscript{15} I.R.C. § 316(a) (1988); see also id. § 301(e)(1).
  \item \textsuperscript{16} See Bittker & Eustice, supra note 10, ¶ 8.03[1] & [2].
  \item \textsuperscript{17} MODEL BUSINESS CORP. ACT §§ 6, 45 (1950) [hereinafter MBCA].
  \item \textsuperscript{18} I.R.C. § 351 (1988).
  \item \textsuperscript{19} MBCA § 19 (1950).
  \item \textsuperscript{20} RMBCA § 6.21 & official cmt. (1984).
  \item \textsuperscript{21} Mountain State Steel Foundries, Inc. v. Comm'r, 284 F.2d 737 (4th Cir. 1960).
  \item \textsuperscript{22} See Bittker & Eustice, supra note 10, ¶ 2.01[1].
  \item \textsuperscript{23} See id. ¶ 2.04.
\end{itemize}
tion with tax law is far more complex than the IRS lets on.

Sometimes tax law gets far ahead of business law. Although there do not seem to be as many examples of this phenomenon, one very good illustration is in the early recognition for tax purposes that holding stock as part of a diversified portfolio is a very different thing from holding stock for purposes of a large investment with the potential for exercising some control over the issuing company.24

II. THE HISTORY OF LIMITED LIABILITY IN TAX LAW

At the risk of restating the obvious, LLCs are popular because they offer partnership-like taxation. That is, an LLC, like a partnership, is treated as an aggregate of the individuals who compose it. Thus there is no entity on which to impose a tax. In contrast, a corporation is viewed as a person in the eyes of the law and is taxed as an entity separate from its shareholders. This leads, of course, to the phenomenon of double taxation, which is the reason that so much time and energy has been spent looking for alternatives to the corporate form. Until the advent of LLCs, however, most of the alternatives had serious shortcomings. An ordinary partnership subjects its partners to the potential of unlimited liability for partnership obligations, though there are important exceptions to this rule.25 A limited partnership avoids this pitfall for all but the general partner, but precludes limited partners from participating in management.26 The S corporation, which allows ordinary corporations with a limited number of shareholders to opt into partnership-like tax treatment, carries with it still other cumbersome limitations, such as the prohibition against alien and nonnatural shareholders, limitations on the number of shareholders, and limitations on the kinds of securities that the corporation may issue (such as prohibiting preferred stock).27 Moreover, the tax rules that apply to S corporations are not, in fact, as attractive as those that apply to partnerships.28

25. There are several ways in which liabilities are in fact limited for partners under partnership law. For example, whereas liability in tort is joint and several, liability in contract is merely joint (at least under the UPA). Even in jurisdictions that have abandoned this rule, it remains the rule that partners are liable only for their proportionate share of other partners' unpaid share of excess debts. See UPA §§ 18(a), 40(d) (1914). RUPA § 807 (1993).
26. UPA § 7 (1916); RUPA § 303 (1993).
27. See BITTKER & EUSTICE, supra note 10, ¶ 6.01-6.11.
28. See id. ¶ 6.11. There are, of course, many other alternative forms of doing business, each with its own peculiar tax wrinkle. See id. ¶ 1.06 (discussing investment companies, REITs, REMICs, small business investment companies, banks and trust companies, insurance companies, cooperatives,
It is important not to lose sight of the history of the tax issues that led
to the invention and growth of the LLC. The Internal Revenue Code, in
section 7701, defines a corporation as including "associations, joint-stock
companies, and insurance companies." 29 Section 761 defines a partnership
as "a syndicate, group, pool, joint venture or other unincorporated
organization through or by means of which any business, financial
operation, or venture is carried on, and which is not . . . a corporation or
a trust or estate." 30 Needless to say, these definitions are rather circular.

The leading case on the classification issue is Morrissey v. Commis-
ioner, 31 in which the Supreme Court upheld an IRS determination that a
trust formed for the purpose of developing real estate (a golf course) should
be taxed as a corporation. But the need for special guidance to distinguish
between partnerships and corporations did not become acute until the late
1950s, when many professionals began to feel the urge to incorporate
themselves in order to gain tax advantages that were available only to
corporations (such as the ability to make pretax contributions to
tax-deferred retirement plans).

A. Professional Corporations

Until about 1960, most states severely limited the ability of professionals
to do business in the form of a corporation (if one could even safely call
practicing a profession doing business in those days), apparently out of an
irrational fear that limited liability for a shareholder would somehow
translate into limited liability for an employee-tortfeasor. In all fairness, the
notion that the corporate form was inappropriate for the professions may
also have derived from the notion that professionals have some kind of
duty to supervise each other's work (though this idea could itself have been
a veiled way to discourage the formation of large firms of professionals
because of the increased risk of liability that would attend the addition of
each new partner). 32

---

30. Id. § 761(a).
32. See generally Stephen E. Kalish, When a Law Firm Member Borrows from a Client—The Law
Firm's Responsibility: A Professional Model Replaces a Club Model, 37 KAN. L. REV. 107, 121-24,
135-41 (1988) (advocating a "professional model" approach to firm responsibility, which makes the firm

https://openscholarship.wustl.edu/law_lawreview/vol73/iss2/6
Although most, if not all, states now have professional corporation statutes, the states are still not completely comfortable with the idea. Thus, the Model Professional Corporation Supplement to the Model Act offers a choice of three different provisions dealing with the liability of shareholders in professional corporations.\textsuperscript{33} One offers standard corporate limited liability, another imposes a partnership-like rule of unlimited liability, and a third allows the state to specify some level of malpractice insurance that must be carried in order to limit the liability of "partners" who were not involved in the activities leading up to liability (which is essentially the same arrangement that Texas recently adopted in connection with its legislation allowing for the formation of limited liability partnerships).\textsuperscript{34}

It may also have been that because limited liability grew up as a feature of manufacturing firms, it seemed wrong for service firms to take advantage of it.\textsuperscript{35} And, at the time, the service firms most likely to try were professional firms. However, in an economy in which over half of the gross domestic product is attributable to service industries, it does not make sense to restrict limited liability to manufacturing firms just because the service industry did not seem to need it when the issue first arose. Indeed, the idea that limited liability should only be available to manufacturing firms seems rather backwards nowadays. The bigger worry is probably over products liability, which suggests that we ought to be somewhat more cautious about extending limited liability to firms that make things than we are to firms that do things. But history works in strange ways.

In any event, it did not seem strange up until about 1960 to think that the corporate form was somehow inconsistent with professional firms or even service firms generally. But the IRS, as is its wont, seized on the distinction between service and manufacturing as reason not to recognize the corporate form in connection with professions (businesses) that had traditionally been practiced in the partnership form. The IRS took the position that a partner in a partnership could not also be an employee of the partnership.\textsuperscript{36} (Perhaps this idea was borrowed from labor law.\textsuperscript{37}) The

\textsuperscript{33} \textit{Model Professional Corp. Supplement} § 34 (1984).
\textsuperscript{35} See supra note 3.
IRS was also apparently concerned that in the context of a one- (or few-) person corporation, and particularly one in which there were few tangible assets, it could be difficult to determine what belonged to the corporation and what belonged to the individual.\textsuperscript{38}

To make a long story still longer, in 1967 the IRS issued regulations designed in effect to test the economic realities of a venture in order to determine how it should be taxed.\textsuperscript{39} The so-called Kintner Regulations identified six characteristics of a corporation: (1) associates; (2) an objective to carry on a business and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) liability for corporate debts limited to corporate property; and (6) free transferability of interests. Because the first two items are also characteristic of partnerships, the IRS took the position that only the last four mattered and that any organization displaying two or more of the four would be classified as a corporation (or association) for tax purposes.\textsuperscript{40}

B. Limited Partnerships and Tax Shelters

The Kintner Regulations were widely regarded as biased against the corporate form. That is, they were seen as setting a relatively high hurdle for establishing that a given firm was a corporation for tax purposes. And, of course, that was precisely what the IRS meant to do. But then came the boom in tax shelters in the early 1970s. A tax shelter is of (tax) necessity a partnership or, more often, a limited partnership (which is taxed the same way). In order to work, the tax shelter must allow losses to be passed through to the partner or limited partner. And such ventures were designed to generate losses by investing in properties in which depreciation deductions could be taken that exceeded the profits expected, at least in the first few years. Needless to say, unlimited liability made the ordinary partnership unattractive. Thus, the limited partnership became the vehicle of choice, and the Kintner Regulations made it fairly easy to assure oneself of partnership tax status.

Even with a limited partnership, however, the general partner (of which there must be at least one) is still exposed to unlimited liability. One popular device for avoiding some of this risk was the nonrecourse loan. Under this arrangement, the lender agreed not to look beyond some

\textsuperscript{38} See Bittker & Eustice, supra note 10, ¶ 2.07 (discussing problems of personal service corporations).

\textsuperscript{39} Treas. Reg. § 301.7701-2 (as amended in 1993).

\textsuperscript{40} Id.
quantum of security given by the firm if there should be a default—a nice deal if you can get it. This tactic led the IRS to adopt “at risk” rules limiting the availability of tax losses to investors who could not be held liable for losses as great as what they attempted to recognize for tax purposes.  

Another way in which the organizers of tax shelters attempted to gain the advantages of limited liability while maintaining partnership tax status was forming a corporation to act as the general partner. In response to such efforts to gain the advantages of partnership tax treatment while avoiding the disadvantages of partnership law itself, the IRS issued additional regulations in 1972 requiring that a corporate general partner have a net worth of at least $250,000 in order for the limited partnership to be treated as such for tax purposes. In 1992, the limit was raised to $500,000. In the view of the IRS, at least, when these amounts are at risk the firm is seen as lacking the characteristic of limited liability.

In the end, both professional corporations and tax shelters were done in taxwise by reform legislation. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress sharply reduced the retirement benefits available on a tax-qualified basis to corporations and increased those that were available to the self-employed so as to eliminate any tax incentive to do business in one form or another. (Nonetheless, the professional corporation does continue to offer some tax advantages that can be quite attractive, such as the possibility of buying health insurance at the firm level and deducting the expense before tax.) The limited partnership tax shelter was dealt with in the 1986 Tax Reform Act by requiring that income and losses be segregated according to the type of activity in which they were generated (ordinary income, investment income, or real estate income) and netted only against like-kind income and losses. This rule made tax shelters essentially useless except to shelter like-kind income. And because their primary purpose had been precisely to reduce taxable income of one type (e.g., ordinary salary or investment income from stocks) by generating losses in another area (usually real estate or oil and gas ventures), the tax

45. See BITTKER & EUSTICE, supra note 10, ¶ 2.06, at 2-29.
shelter was dead for most purposes (though anyone who might want, for example, to shelter real estate income against other real estate income could still do so). 48

There was, however, one last detail. In 1981, the first so-called master limited partnerships (MLPs) were formed under Delaware law. 49 The MLP differed from the plain vanilla limited partnership primarily in that shares in an MLP could be freely transferred and thus could be publicly traded. No doubt the original idea behind the MLP was to make the benefits of tax shelters available to the masses, and thus to generate fees for promoters and dealers. But MLPs turned out to be attractive for ordinary businesses, not just tax shelters, because they offered, in effect, a way to opt out of the corporate tax system. 50 So, the Revenue Act of 1987 dealt with MLPs by mandating that publicly traded partnerships (other than real estate and oil and gas ventures) be taxed as corporations. 51

III. LIMITED OR UNLIMITED LIABILITY AS A SIGN (AND OF WHAT?)

The point for present purposes is that tax law treats partnerships and corporations very differently and therefore needs to distinguish between the two somehow. Unless there is some objective way of telling the two apart, a business may be able simply to choose to which tax scheme it will be subject. To be sure, one might legitimately ask why a business should not

48. It bears noting that these changes in tax law more or less coincided with the crash of the real estate market and the ensuing recession. Although the overbuilding caused by the perverse incentives of tax shelters would eventually have caught up with itself one way or another, there can be little doubt that the 1986 Tax Reform Act accelerated the process. Moreover, at the same time, securities regulators were in the process of cracking down on junk bonds, with the ultimate effect that the secondary market for such securities was more or less destroyed, at least for several years. Thus, two of the most important stores of wealth (real estate and the bond market) were severely compromised more or less at the same time. Although it seems somewhat remarkable in hindsight that the collapse of the high-yield bond market did not lead to soaring interest rates, it may well have been that the lack of capital—exacerbated by the thrift crisis, which was also connected to the events in the real estate and bond markets—simply brought growth to a halt and, far from making money scarce, made investment opportunities even scarcer, with the result that there was little or no demand for money and interest rates plummeted.


50. The MLP would presumably only be attractive for a company willing to pay dividends adequate to cover the income that would flow through to limited partners, given that for tax purposes, income in MLPs would flow through to the limited partners whether or not cash was distributed. Ironically, this development could be seen as a form of voluntary assumption of less limited risk by investors somewhat akin to unlimited liability.

be able choose how it will be taxed.\textsuperscript{52} More on that later. But tax law has not taken that tack. Rather, tax law has seized on certain indicators of corporateness in order to determine the "economic realities" of a business. And until very recently, limited liability was perhaps the most important such indicator.

But what is so special about limited liability? The question has more than academic significance. Tax law is supposed to be neutral.\textsuperscript{53} If it latches onto the wrong feature in making a distinction, it creates incentives to structure an organization or transaction in such a way as to gain tax advantages rather than in the way that makes the most sense from a business point of view. This is not to deny that many deals are tax-driven, but only to say that ideally they should not be. Nevertheless, one of the goals of tax law is to raise revenue without affecting the way the golden goose goes about her business.

Again, what is (or was) so special about limited liability? Nothing really. As I have argued elsewhere, limited liability is a myth.\textsuperscript{54} It means very little in the context of a one-person corporation, and by the time the corporation becomes any larger, the principals will have enough at stake that they will not likely risk it by pursuing lines or methods of business that may bankrupt it. Thus, limited liability is more of a contracting device designed to allow principals to decide how much of their wealth to put at risk in a business venture (or at least to know how much is at risk given that often they will, in the end, be asked by their creditors to put everything on the line).\textsuperscript{55}


\textsuperscript{53} This ideal has broad-ranging implications for how tax law should be structured. For example, it led the American Law Institute in 1989 to note that the tax rate on corporations has traditionally been and should again be made somewhat lower than personal rate so as not to unduly discourage use of the corporate form. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, REPORTER'S STUDY DRAFT 48-50 (1989). Corporate tax rates had been increased relative to individual rates in the 1986 Tax Reform Act, but consistent with the ALI's suggestion, Congress changed the tax rates back to the pre-1986 relationship in 1993. The obvious way to deal with this problem is to do away with the corporate tax altogether, an idea that was at least toyed with in the lead-up to the 1986 Act and that is implicit in the continuing campaign to integrate the corporate tax with the individual tax. See ALVIN C. WARREN, JR., REPORTER, AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993).


\textsuperscript{55} Larry Ribstein has taken the further step of arguing that because limited liability makes sense, it ought to be the norm. As he sees it, although one can trace the boom in LLCs to tax motivations,
In addition, to test the status of a firm by reference to whether it affords limited liability to its investors begs an important question. Why is it that limited liability indicates that the organization in question is more like a corporation than it is like a partnership? The easy answer is that partnership law works that way. The tough question is: Why does partnership law work that way? In order to answer this question, one must go back to the definition of partnership.

A. Unlimited Liability in Partnership Law

Under section 6 of the Uniform Partnership Act, a partnership is defined as “an association of two or more persons to carry on as co-owners a business for profit.” In other words, in order for a venture to be considered a partnership, it must be a for-profit business, and in order for an individual to be considered a partner, he or she must be an owner of the business. Otherwise, partnership law will not apply and none of the consequences of it, such as unlimited liability for partnership obligations, will follow.

The definition of partnership excludes a number of interesting entities. For example, a private club, such as a country club, does not qualify because it is not in business for profit. Rather, the benefits of the business, if one can even call it a business, are received in kind, in the form of use of the facilities. Similarly, a lodge, or a church, or a consumer cooperative, or a lobbying organization will not be considered a partnership.

much of its more recent vigor can only be explained by the fact that it makes sense as a matter of nontax considerations. Larry E. Ribstein, Limited Liability and Theories of the Corporation, 50 Md. L. Rev. 80 (1991).

56. UPA § 6 (1914).

57. See, e.g., Azzolina v. Order of Sons of Italy, 179 A. 201 (Conn. 1935) (holding that members of lodge who paid construction debt were entitled to reimbursement from those who assented to obligation); Security-First Nat'l Bank v. Cooper, 145 P.2d 722 (Cal. Dist. Ct. App. 1943) (same); Cousin v. Taylor, 239 P. 96 (Or. 1925) (finding liability only as to members of lobbying organization who voted in favor of hiring expert); Meriwether v. Atkin, 119 S.W. 36 (Mo. Ct. App. 1909) (finding no liability against president who merely appointed committee to study project); Libby v. Perry, 311 A.2d 527 (Me. 1973) (extending liability in tort only to those who participated in planning activity); Lyons v. American Legion Post No. 650 Realty Co., 175 N.E.2d 733 (Ohio 1961) (same).

Tax shelters potentially present unique issues in this area. In a sense, the primary purpose of a tax shelter is to generate losses (at least in the early years of operation), thus generating gains—in the form of tax savings—that have little to do with the success or failure of the business. Thus, one of the questions is whether one can maintain an action against the managers of a tax shelter for poor management. An even more common question is whether an investor who purchases a tax shelter because of some sort of misrepresentation as to its value is entitled to recover the difference between what he or she paid and what the participation was worth, or whether the investor must set off the tax

https://openscholarship.wustl.edu/law_lawreview/vol73/iss2/6
B. Independent Contractors

As it turns out, profit-seeking is a key feature of numerous legal relationships that visit liability on parties beyond the wrongdoer. Although partnership law is more explicit about the importance of profits, the law of vicarious liability in tort offers a more dramatic example of the difference profit-seeking makes in determining the liability of a principal. When an agent commits a tort, the liability of the principal will depend on whether the agent is an independent contractor or an employee.\(^{58}\) If the agent is an employee, the principal-employer will be absolutely liable for damages arising within the scope of employment.\(^{59}\) On the other hand, if the agent is an independent contractor, the principal will not be liable for the torts of the agent.\(^{60}\) Needless to say, scope of employment leaves much room to maneuver, and an employer may indeed avoid paying damages by showing that somehow the employee was on a frolic of his own.\(^{61}\) Even if it is established that an agent is an independent contractor, the principal may still be held liable if the tort involved either an ultrahazardous activity or a nondelegable duty. Nevertheless, the general rule is that the employer pays while the “contractee” does not.

In order to establish an agency relationship—whether it involves an independent contractor or an employee—it is often said that there must be (1) assent by both parties, (2) the expectation of benefit to the principal, and (3) control by the principal.\(^{62}\) Curiously, the same three factors are

benefits against the loss. Arguably, if such securities are efficiently priced, the two ways of calculating damages should work out to the same number. On the other hand, where the claim is based on the idea that such investments (even if they were properly priced) were unsuitable for those to whom they were sold (as is the case in the massive settlement with Prudential Securities) then the issue takes on a new relevance.

Interestingly, there has been little worry about whether tax shelter participations constitute securities. Perhaps because of the potentially crushing liabilities under the federal Securities Act of 1933, everyone seems to have assumed that they are. See Karin J. Birkeland, Case Comment, Securities Fraud: The Tax Benefit Offset Rule of Damages in Securities Litigation, 70 M/MN. L. REV. 1185 (1986); Dan L. Goldwasser & Vicki L. Safran, Damages in Tax Shelter Offerings, 18 REV. SEC. & COMMODITIES REG. 225 (1985).

\(^{58}\) In traditional parlance, employer and employee are referred to as “master” and “servant”; but because such terminology is both archaic and somewhat offensive, the terms “employer” and “employee” will be used here. See RESTATEMENT (SECOND) OF AGENCY § 2 & official cmt. (1958); see also id. § 220 & cmt. e.

\(^{59}\) Id. § 219.

\(^{60}\) Id. § 2(3) & cmt. b.

\(^{61}\) Id. §§ 219, 228-237.

\(^{62}\) Id. § 1.
often cited as the elements of an employer-employee relationship. The difference between the two tests is most often said to be a matter of the intensity of the control involved. As the Restatement (Second) of Agency points out in section 220, an employee is an agent who "is subject to the principal's control with respect to . . . physical conduct in the performance of services." The distinction can fairly be characterized as one between the right to specify merely the intended result of the agent's services (in the context of an independent contractor) and the right to dictate the manner in which the services are to be performed. Practically speaking, however, there are many employees whose skills are so exotic that the employer could not hope to direct the employee's activities in any detail. Consider a brain surgeon employed by a hospital, or a mathematician employed by a brokerage house, or indeed a specialist in corporation law employed by a law school. Thus, the courts have often resorted to the convenient observation that it is the right to control and not the exercise of control that matters.

The truth is, however, that control is a less reliable factor and in many cases a less important factor than benefit, though few courts have bothered to articulate the benefit factor in any detail. While I have not done any

---

63. Id. §§ 2, 220.
64. Id. § 220 & cmt. e.
65. See id. § 220 cmt. d.
66. Two very good examples of cases in which the courts do look for the ultimate beneficiary and then impose an agency relationship are Lubbock Feed Lots v. Iowa Beef Processors, 630 F.2d 250 (5th Cir. 1980) and A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981). In both of these cases, the court held the ultimate purchaser of a commodity liable to the customers and other creditors of the nominal seller on the theory that the purchaser had in essence propped up the seller financially, presumably in order to appropriate the benefits of the relationship. Such cases may be thought of as akin to undisclosed principal cases, but in both it was well known by third parties that Iowa Beef and Cargill, respectively, were the ultimate buyers and financial supporters of the nominal purchasers.

Such findings of constructive agency are similar to cases of inadvertent partnership, with the important potential difference that in an agency case in which the principal is known it should be arguable that the agent is not bound. I know of no cases in which such an argument has been advanced, let alone in which it succeeded. Indeed, if the agent in such a case is solvent, it would be needless to make such an argument, and if the agent is insolvent, as is usually the case, it is futile to make such an argument. Nevertheless, given the fact that liability in such cases is simply extended to another (usually corporate) party, it is difficult not to notice the parallel with cases of piercing the corporate veil, though in the instant situation there is nothing but a contractual relationship between the two entities. Indeed, as I have argued elsewhere, piercing the corporate veil is really only a special application of agency principles (though admittedly, the point is usually made in the context of involuntary (tort) creditors). See Booth, supra note 54, at 161-65. Oddly enough, the ultimate benefit argument (which is by its nature likely only to arise in contract cases) has not fared well in the courts as grounds for piercing the corporate veil. See, e.g., Bartle v. Home Owners Coop., Inc., 127 N.E.2d

https://openscholarship.wustl.edu/law_lawreview/vol73/iss2/6
empirical research on this subject beyond gathering the usual anecdotal evidence, it seems clear that the courts are just as concerned, and maybe more so, with who really owns the business of the agent. In other words, is the agent in business for profit himself, or are the profits of the agent somehow commanded as part of the principal’s business? Section 220 of the Restatement, after stating in essence that the right to control physical conduct is the key, goes on to list ten factors to be considered in determining whether an agent is a servant. Without belaboring the point, however, while many of the factors are indicative of control, just as many seem to focus on whether the agent is in business. (Oddly enough, the last of the ten factors, “whether the principal is or is not in business,” is nowhere discussed in the comments.)

C. Piercing the Corporate Veil

As I have pointed out elsewhere, the law of piercing the corporate veil is really only a special case of vicarious liability. Indeed, many of the more recent leading cases have seemed to focus on the prospect of profit as one of the key factors in determining whether to respect a corporation’s borders. Where a corporation has been set up or run in such a way that there is no prospect of profit, or so that it will likely absorb any large losses that might befall another supposedly independent business, the courts have been quite ready to collapse the two into one.

---

832 (N.Y. 1955).

Although in most cases the (constructive) principal presumably will be held liable for all of the obligations of the (constructive) agent (or at least those contractual obligations that can be traced to the principal’s imetus), in some cases the courts have taken the additional and quite remarkable step of limiting the liability of the principal to the amount invested in the agent or the amount the agent was authorized to spend. See, e.g., Senor v. Bangor Mills, Inc., 211 F.2d 685 (3d Cir. 1954). Such an approach is rather like granting constructive limited liability in situations in which the principal propped up the agent financially but did not create the appearance of ultimate capacity to contract from the point of view of reasonable third parties.

68. Id.
70. But see Bartle, 127 N.E.2d at 833 (relying on other grounds in refusing to pierce the corporate veil).
71. See Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958) (subordinating claims of two partners to those of general unsecured creditors in bankruptcy where partners, in process of incorporating their business, withdrew a large part of their capital contributions, leaving the entity severely undercapitalized). See generally WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION & FINANCE 57 (3d ed. 1988) (discussing the need for equity capital adequate to absorb risk of venture). This is yet another area in which tax law tracks business organization law. One of the key factors in allowing a
D. Definition of Security

Another area in which the prospect of profit has been seized upon as a bright-line distinction is in the notoriously murky issue of what constitutes a security. In one of the leading cases, United Housing Foundation, Inc. v. Forman, the Supreme Court was faced with the question whether shares of stock in a New York business corporation (not a nonprofit corporation) set up to own and operate a cooperative apartment building complex (Co-Op City) were securities for purposes of a fraud action under the Securities Exchange Act of 1934. One of the leading formulations of the definition of a security is that a security is an investment contract holding out the prospect of profit primarily through the efforts of others. In the Co-Op City case, the plaintiffs argued that they were induced to buy shares because shareholders were entitled to live in an apartment at the complex which were built with low-cost state financing and were therefore cheaper than alternative housing in New York City. Moreover, by virtue of their share ownership, owners would be allowed to deduct their share of interest and taxes for income tax purposes. Thus, plaintiffs argued that there were significant economic benefits flowing from ownership of shares and that the shares should be considered securities. The Supreme Court disagreed, seeing a distinction between the benefit of a low-cost apartment and the prospect of profit, and citing the fact that a Co-Op City shareholder could not resell shares at a profit.

E. Insider Trading

Yet another application of the profit motive as a bright-line distinction is in connection with insider trading. The Supreme Court has twice rejected the notion that the mere possession of inside information creates a duty to disclose or abstain from trading. Instead, the Court has ruled that in order to make out a case of fraud under federal securities law, it must be shown that the trader not only possessed material nonpublic information, but also had a duty not to use it. Thus, it must be shown that the trader had a fiduciary or similar duty either to the person on the other side of the trade.

taxpayer to deduct business expenses is whether the taxpayer is at risk. See I.R.C. § 465 (1988).
75. 421 U.S. at 851.
or to the source of the information.\textsuperscript{76}

In most cases, it is not all that difficult to establish that a trader or a tipper has the requisite duty. But the courts have struggled with cases in which there was no clear profit motive. Thus in the seminal case, \textit{Dirks v. SEC},\textsuperscript{77} the Supreme Court held that where a securities analyst was informed of material nonpublic information by a whistle-blowing employee, the fact that the employee did not benefit monetarily from the disclosure absolved him of the charge of breach of fiduciary duty, and the tippee was absolved because the information was not improperly disclosed.

Then, in \textit{United States v. Chestman},\textsuperscript{78} the Second Circuit, sitting en banc, held that no fiduciary duty arose on which to predicate fraud where fifth-hand information about a planned tender offer had passed from family member to family member. Several of the family members had no active involvement in the business and no expectation of profit from the business beyond a general hope that someday they might inherit some stock. (The trader was, however, convicted on the basis of another SEC rule that effectively created a presumption that information in connection with a tender offer is improperly disclosed.\textsuperscript{79})

Judge Winter dissented in \textit{Chestman} with regard to the existence of a fiduciary duty, arguing that it is important to recognize property rights in information generated in connection with a profit-seeking venture.\textsuperscript{80} Further, he noted that the receipt or expectation of benefits increases the interest of a family member in corporate affairs and thus increases the chance that he will learn confidential information. Judge Winter recognized, consistent with \textit{Dirks} but nonetheless somewhat paradoxically, that the rule against insider trading cannot extend to all instances of trading on material nonpublic information. A rule requiring equal access would reduce the incentive to obtain information—the importance of property rights intervenes again—and would reduce the efficiency of the market. Thus, Judge Winter would have drawn the line based on how the information is obtained, outlawing those cases in which the information was used in an unintended way. In short, while the two camps disagreed about whether there existed a fiduciary or similar relationship in the context of an extended family, they agreed that the prospect of profit, one way or the


\textsuperscript{77} 463 U.S. 646 (1983).

\textsuperscript{78} 947 F.2d 551 (2d Cir. 1991).

\textsuperscript{79} Id; see also Sec. Exch. Act Rule 14e-3, 17 C.F.R. § 240.14e-3 (1994).

\textsuperscript{80} 947 F.2d at 576-81 (Winter, J., dissenting).
other, was the key to the determination.

It may not at first seem all that surprising that the line between duty and no duty (as well as breach and no breach) is drawn with reference to the profit motive. After all, what worries (some of) us about insider trading are the (supposed) losses visited on the innocent shareholders on the other side of the trades. If one eliminates (or at least catches) the insider trading that is somehow connected to the prospect of profit, then whatever insider trading is left will be of little worry. But if one accepts the idea that the important interest to be protected is the interest of the firm in its information, then the motive for disclosing the information matters little as long as the firm wants the information to remain secret. One who subscribes to this view might also argue that different people have different notions of benefit. A whistleblower might derive considerable satisfaction from disclosure, and indeed might derive greater satisfaction if disclosure does more damage to the corporation’s interests. And even if the whistleblower’s motives are lofty, it still may be that he derives a personal benefit from being or being seen as a highly moral person. Nonetheless, we tend to draw the line at benefits that are economic or readily capable of being valued in dollar terms. Why?

F. Mergers and Acquisitions

The traditional rule in corporation law has been that a fiduciary may not benefit from a transaction with the corporation. 81 Thus, in a merger where a controlling parent corporation forces out the minority shareholders of a subsidiary corporation, it has been argued that the parent should be made to disgorge any profits. 82 While the Delaware courts were initially quite aggressive in enforcing this notion, they have since 1983 pushed beyond such a simplistic approach, recognizing in effect that every deal must be


82. The high-water mark for this rule came in Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981). There, the Delaware Supreme Court, nearing the end of what could be called a temporary crackdown on interested mergers, held that in an appropriate case shareholders who had been cashed out in a transaction violative of fiduciary duty could be awarded all the profits realized by the parent company in connection with the merger up to the date of judgment. Even this case, however, conditions recovery on a failure to disclose at the time of the transaction, thus leaving some room for profit by the parent-fiduciary. For a case in which the court essentially held that the controlling shareholder could not profit to the exclusion of outside shareholders, see Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955).
motivated by a disagreement about value, and that a fiduciary may well be in the best position to disagree with noncontrolling owners of the corporation.\textsuperscript{83} What sense does it make, then, to eliminate the fiduciary as a potential trading partner? Thus, the courts of Delaware have held that the law should seek to ensure that a fair negotiation is conducted rather than seek to eliminate the worrisome profits that a fiduciary may enjoy.

IV. THE IMPORTANCE OF SEEKING PROFITS

The question is: Why does profit-seeking matter so much in defining the legal status of a relationship or organization? There are several possible answers.

First, it may be that as a matter of policy, possibly based on some statistical intuition, the danger of fraud or even mere insolvency is somehow enhanced in the context of profit-seeking ventures. That is, it may be that individuals involved in a business for profit are more likely to renege on their contracts or walk away from other sorts of obligations that may be generated in the course of their business.

Second, it may be that unlimited liability is somehow viewed as the quid pro quo for the privilege of being in business. In other words, it is seen as only fair that if someone stands to make money at a venture, he should also be prepared to pay for any losses, just as a gambler is expected to pay up on his losing bets. In a similar vein, unlimited liability may be seen as a kind of licensing fee or tax imposed on profit-seeking ventures (albeit a contingent tax) simply because they are there to be taxed, or perhaps reflecting some kind of distaste for business.

Third, unlimited liability may also be seen as a mild effort to restrain trade. By holding up the spectre of unlimited liability, perhaps it was thought that the riffraff would think twice about getting into business. This explanation assumes, of course, that the riffraff knows about the consequences of partnership law, and cares. It may be more of a disincentive to someone who has property to lose if the business does go belly up.

Fourth, it may be that profit-seeking is a surrogate for other, difficult-to-determine features of a business. For example, it may be that the true quest of the law is to determine who is ultimately most responsible for putting into motion a series of events that eventually visits a loss on some third party. The presumption that the owner of a profit-seeking venture should

be liable (possibly in addition to the individual wrongdoer, depending on the nature of the wrong) is just that—a presumption that if the owner's motivation is profit, the event would not have occurred but for the owner's intent that it occur.

Finally, one is tempted to argue, with some circularity, that because the owner of a business is potentially liable for losses, he or she will assume control of any decision that entails the risk of loss, and thus it is fair to presume that when such events come to pass it was the owner who ultimately was behind the course of action leading up to it. It may be for this reason that partnership law (or the cases interpreting it) tends to focus more on agreements to share losses than on agreements to share profits. The problem with this explanation is that it assumes that the owner is going to be liable. If there were no rule of personal liability, then owners would not worry about losses so much.

Or would they? There is more than one kind of loss out there. The loss that visits a cost on some third party is the one that usually comes first to mind, and it is the one that the law is most concerned about. But from the owner's point of view, lost opportunities (opportunity costs) may be much more important. And such losses entail no real potential for any sort of legal liability. Nevertheless, if being in business suggests that one is more likely to be on the lookout for opportunities to increase revenues and to cut costs, then perhaps it makes sense to presume that when something goes wrong the owner is ultimately behind it. Or to put a slightly more positive spin on it, business owners are more likely to focus on ways to reduce costs than are mere consumers, so why not harness some of that energy to make the world a safer place in which to live?

This last explanation for why liability follows profits is the most satisfying explanation, though at first it may seem a bit farfetched. Still, something along these lines is the best explanation yet offered for vicarious liability. We want owners to worry about losses. Still, there is nothing special about losses that arise in connection with profit-seeking ventures. To be sure, some such losses would not arise but for the venture. That is, some risks are created more or less on purpose. Nevertheless business, simply because it is a business, is also held liable for flukes.

84. See UPA § 7(4) (1914) (listing several schemes of profit sharing that do not evidence partnership).
The ultimate answer to this mystery may lie in the very idea of profit. Just what is "profit" anyway? Most simply and most generally, one might say that profits are the difference between cost and benefit. That is, profits are the gain that comes from trading something of value for something of more value. Thus, most human activity is in some sense profit-seeking. The idea of "satisficing" notwithstanding, people do things because they expect their actions to have some benefit in the long or short run. Indeed, one noted commentator has even argued that the implicit rental value of an owned residence should be treated as income for tax purposes.86

The law has never settled for such a definition of profits (or income, as the case may be). As a matter of agency law, mere personal benefit is not enough. A contemplated benefit must ordinarily be economic in order to visit liability on a principal for an agent's torts.87 And as a matter of securities law, a distinct economic benefit such as tax savings may not be enough to qualify as "profits."88 Is simply assuring oneself of a job at the same rate of pay that would be available working for someone else enough to rise to the level of profit?89 An economist would say that working merely for fair pay is not enough, just as investing for a fair return does not constitute profit in the economic sense. Although it is not so clear that partnership law would follow where the economist would lead, it would nonetheless be interesting to see how the law would deal with a "partnership" the avowed purpose of which was to break even after fairly compensating its "partners." Or does partnership law somehow deal with this question in providing that a partner is not entitled to be paid?90

In short, the idea of profit, from which flows the idea of unlimited liability, and ultimately the idea of limited liability, is itself fairly slippery. To put it simply, the law has never defined very precisely exactly what it

---

87. See, e.g., Restatement (Second) of Agency § 238 & cmt. b (1958).
89. This is not merely an academic point. A sole proprietor of an unincorporated firm may not bother to segregate compensation from the income of the business. Yet if the proprietor desires to sell the business or to transfer it to a corporation in exchange for stock (and perhaps to take on additional shareholders in the process), it is vital that in connection with valuing the business and setting the price the parties subtract some reasonable amount from the nominal income of the business in order to account for what would need to be paid to the proprietor as a salary if he or she were working for someone else. Otherwise the value of the firm will be overstated. See David R. Herwitz, Business Planning 44-45 (temp. 2d ed. 1984).
90. See UPA § 18(f) (1914).
means by profit, and thus the extent of liability for the acts of others has
never been totally clear. Fortunately, however, it no longer matters for tax
purposes. Practically speaking, the line between firms that will be treated
as corporations for tax purposes and firms that will be treated as partner-
ships has shifted from one determined largely on whether the firm has
limited liability to one determined largely on whether the firm is (or could
be) publicly traded.

Is there some good reason for this shift (other than a vague academic
worry about the integrity of the concepts of unlimited liability and
ultimately profit-seeking)? You bet. In the first place (again), limited
liability is illusory for the smallish firm. It is better seen as a contracting
device than as any kind of absolute benefit.91

Second, the existence of a ready market for shares has become the
primary distinguishing feature between business organizations with
partnership-like attributes and those with classical corporate attributes.
Nowhere is this more apparent than in connection with the development
of a distinct body of law governing closely held corporations. As the courts
began to recognize in the 1960s, a shareholder-manager who depends on
a small corporation for a job (and incidentally may hope to make a genuine
profit someday) and who cannot readily exit from the firm if dissension
develops needs more protection from oppressive tactics that may be
undertaken by fellow shareholders (who might seek to make life uncomfort-
able for, or even oust altogether, those who disagree). In such situations,
the courts have imposed partnership-like duties running from shareholder
to shareholder, rendering oppressive tactics—that would go unchecked in
an ordinary corporation—remediable where they arise in the context of a
closely held corporation.92 In addition, the courts have upheld contracts
among shareholders that would ordinarily be struck down as purporting to
bind the board of directors,93 and many state legislatures have taken the
cue to enact special close corporation statutes offering greater flexibility in
governance as well as enhanced shareholder duties and remedies.94
Interestingly, in granting these special protections to shareholders in closely
held corporations, the courts have focused on the key issue whether there
exists a ready market for the shares of the company, and the legislatures

91. See supra text accompanying notes 54-55.
94. See, e.g., DEL. CODE ANN. tit. 8, §§ 341-356 (1991); NEV. REV. STAT. §§ 78A.010-.200
(1993).
have restricted the availability of such benefits to companies whose shares cannot be publicly traded.\textsuperscript{95} It should thus come as no surprise that the IRS followed suit and made partnership taxation effectively available to the close corporation (while Congress denied the same to master limited partnerships).\textsuperscript{96}

Third, the existence of a public market for shares means more than simply that shareholders gain the benefit of liquidity. When a firm's shares become publicly traded, investors become free to diversify. Indeed, a rational investor will not fail to diversify because with diversification he can achieve the same level of return at lower risk.\textsuperscript{97} To put it another way, an investor who fails to diversify takes more risk than he needs to take and thus receives, on average, less than a market rate of return. Thus a portfolio-oriented investor buys something quite different from the stock that an owner-manager owns. Though the pieces of paper they receive are identical (except for the serial numbers), their reasons for investing are very different and the risks they take (and hence necessarily the return they expect) are therefore different. Indeed, when one considers the strictures of securities law (and to a lesser extent tax law), the legal rights that attach to identical shares can be very different.\textsuperscript{98}

A number of commentators have seriously suggested that limited liability is an anachronism in an age of solicitude for social cost and should be eliminated.\textsuperscript{99} In practice such proposals would likely boil down to some scheme of imposing unlimited liability on a few large institutional shareholders if only because it would be tremendously expensive to pursue thousands of individual shareholders.\textsuperscript{100} But because large institutional shareholders are extremely well diversified, the chances are that they already suffer much of the loss they would suffer from a rule of unlimited liability.\textsuperscript{101} Presumably, when a publicly traded company finds that it is liable for more in damages than it is worth, much of the loss will fall on other businesses that have done business with it (such as suppliers, customers, banks, insurance companies, and transportation companies, to

\textsuperscript{97} See Posner, supra note 12, at 405-10.
\textsuperscript{98} For a fuller explanation of these differences, see Richard A. Booth, The Other Side of the Management Compensation Controversy, 22 SEC. REG. L.J. 22 (1994).
\textsuperscript{99} See Hansmann & Kraakman, supra note 11, passim.
\textsuperscript{100} See id.
name just a few). The prices of the stocks of those businesses will fall accordingly, and a well-diversified shareholder will see the value of his portfolio decline by much of the loss that would have passed through under a rule of unlimited liability.

Moreover, even if a business does not do business with the offending business, the mere occurrence of an event that forces the bankruptcy of a publicly traded firm will likely raise the consciousness of investors regarding such risks and will cause a general decline in the prices of stocks of similar companies. Though perhaps it should go without saying, these declines do not need to be large in the case of any one stock to add up quickly to as much damage as is done to the victims. In other words, it is hardly necessary that news of Bhopal be followed by a crash of the stock market in order for investors in the aggregate to be charged for the accident. A one-eighth-of-a-point decline in a few stocks may be perfectly adequate. These losses do not, of course, constitute money in the pockets of the victims, but they do have the effect of making capital more expensive and thus of either curtailing operations that entail such risks or forcing companies that engage in such activities to raise more capital to cover for them.

The proverbial bottom line is that limited liability is illusory for publicly traded companies too, because investors in such companies tend to be well diversified, and the price of being well diversified is to reassume exposure to liability equivalent to forgoing limited liability. The fact that no shareholder is ever forced to dig further into his pocket to pay is irrelevant—unless of course the critics are really out to exact punishment rather than simply to cover social costs. But it is not so high a price that anyone has suggested that diversification is not worth it.

So what does all this have to do with LLCs? Plenty. LLCs are the more or less final step in a transformation of the law of business associations and its reconciliation with tax law. Little has changed as a matter of substance with regard to the law of business associations. Limited liability was already readily available, but it was illusory anyway. And it is just as complicated to form a LLC as it is to form a corporation—perhaps a bit more so. The real difference is on the tax side. Some have argued that the LLC effectively gives firms the ability to choose whether they will be taxed

102. It is a crucial fact that in the aggregate and over the long haul, business makes money for its equityholders. See JAMES H. LORIE ET AL., THE STOCK MARKET: THEORIES AND EVIDENCE 16-17 (2d ed. 1985) (reporting that over the years 1926-1981 the geometric average return on common stocks was approximately nine percent).
once or twice. In a sense, that is true. But for smallish firms it was always possible, more or less, to opt out of the corporate tax, if not formally (say, by becoming an S corporation), then informally by zeroing out income through bonuses, perquisites, and other efforts to load up expenses. And for large firms with a need for public capital, the option to be taxed as a corporation or not is a Hobson’s choice—no choice at all. If a firm needs access to the stock market, it must opt into the corporate tax. Of course, there are a few very large firms out there that remain privately held and that arguably should be subject to the corporate tax because they are large enough to be publicly traded. But the fact is that such a firm could always have organized itself as a partnership or limited partnership anyway. And there is the question of how we should treat a company that chooses only to sell debt securities publicly. But again, the return on debt securities is only taxed once as it is—the firm itself may deduct the interest before tax. So such tactics were possible under the old regime as well. In short, the ready availability of LLCs comes close to drawing the line between entities that should be subject to double taxation and entities that should be subject to single taxation right where it should be drawn, between firms that are publicly traded and firms that are not. Moreover, the elimination of perverse tax incentives has given us a clearer picture of what matters in choosing a business form. And quite clearly, folks are flocking to forms that offer limited liability.