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## DELAWARE LLCs AND VEIL PIERCING: LIMITED LIABILITY HAS ITS LIMITATIONS<sup>†</sup>

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### I. INTRODUCTION

This article discusses the application of veil piercing to limited liability companies (“LLCs”) organized under the Delaware Limited Liability Company Act<sup>1</sup> (the “Act”). The doctrine of veil piercing permits courts, under some circumstances, to disregard an entity’s form and the protections from personal liability otherwise accorded to equity holders.<sup>2</sup> The Act itself does not address veil piercing and the courts of Delaware have not ruled definitively on the issue. Nevertheless, there is ample reason to conclude that some form of veil piercing is applicable to Delaware LLCs.

The doctrine of veil piercing has been the subject of numerous judicial decisions and scholarly commentary in other contexts, albeit not

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1. Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6, §§ 18-101–18-1109 (2003).

2. See generally David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427 (1998) (discussing doctrinal development of veil piercing by contrasting freedom of contract and the need for regulation); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991) (evaluating judicial application of veil piercing in light of claims made by commentators about decisional structure and doctrinal factors).

entirely eliminating ambiguity even in those contexts.<sup>3</sup> The doctrine most often arises in connection with plaintiffs' attempts to hold corporate shareholders liable for the debts of the corporation.<sup>4</sup> In order to make some observations regarding the applicability of veil piercing to LLCs, and particularly Delaware LLCs, one must consider the limited liability provisions of the Act as well as relevant judicial decisions and scholarly commentary.<sup>5</sup>

## II. LIMITED LIABILITY COMPANIES—GENERAL

LLCs represent a hybrid between corporations and partnerships.<sup>6</sup> They are specifically authorized by, and formed under, the Act.<sup>7</sup> Depending on the provisions of the entity's limited liability company agreement, also known as an "operating agreement," management rights may be vested in either managers or members, and may be centralized or decentralized.<sup>8</sup> Most LLCs are closely held and member-managed.<sup>9</sup> Limited liability for members and managers, pass-through income taxation, flexibility in defining rights incident to membership interests, as well as broad latitude in allocating profits and losses are among the more prominent characteristics of LLCs.<sup>10</sup>

The LLC form of business organization is relatively new in the United States.<sup>11</sup> As a result of changes in federal tax regulations that ensure partnership tax treatment in most cases, as well as a number of other advantages over corporations, LLCs have become increasingly

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3. See Cohen, *supra* note 2, at 428 (observing that discussion so far has centered on corporations); Thompson, *supra* note 2, at 1036 (noting that although veil piercing is the most litigated issue in corporate law, it remains among the least understood).

4. See generally CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW §§ 6.01[1], 6.03[1] (1994 & Supp. 2004).

5. This article does not purport to address all possible bases for personal liability under the Act or other applicable law, including tortious or otherwise wrongful conduct on the part of members or managers.

6. See Cohen, *supra* note 2, at 452.

7. DEL. CODE ANN. tit. 6, §§ 18-106, 201 (2003).

8. See DEL. CODE ANN. tit. 6, §§ 18-215, 402, 404 (2003).

9. See Cohen, *supra* note 2, at 460.

10. Fredric J. Bendremer, *Those Delaware LLCs—Another Look: How They Could Work for You*, BUSINESS LAW TODAY, May/June 2001, at 43, 48.

11. *Id.* at 43.

popular in recent years.<sup>12</sup> Delaware is often considered the jurisdiction of choice for forming LLCs due to its well-developed body of business law and business-oriented courts and legislature.<sup>13</sup> The law regarding many LLC issues, including veil piercing, however, still is in the process of development and evolution.

In any discussion of LLCs it must be emphasized that although the Act contains a number of important provisions, the Act leaves many of the details regarding particular LLCs and the relationships among the parties to the parties themselves.<sup>14</sup> The Act itself emphasizes the principle of freedom of contract and the enforceability of operating agreements.<sup>15</sup> In reality, LLCs therefore are largely creatures of contract.<sup>16</sup>

### III. LIMITED LIABILITY UNDER THE ACT

While the Act provides great flexibility for members and managers to define their relationship to the LLC and to each other, it also contains several provisions that address their liability, or lack thereof, to third parties. The following sections describe the Act's core limited liability provisions.

#### *A. Members and Managers*

Limited liability is a critical component of the Act. Particularly, section 18-303 of the Act states that except as otherwise provided by the Act, the "debts, obligations and liabilities of a limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities" of the LLC.<sup>17</sup> Section 18-303 of the Act further provides that no member or manager shall be "obligated personally for any such debt, obligation or liability . . . solely by reason

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12. The federal tax regulations, known as the "check-the-box" rules, became effective on January 1, 1997. Treas. Reg. §§ 301.7701-1–301.7701-3 (1996).

13. Vicky L. Mayfield, *Limited Liability Companies in Delaware and Tennessee: A Comparative Approach*, 5 TRANSACTIONS: TENN. J. BUS. L. 329, 329 (2004).

14. See *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999).

15. DEL. CODE ANN. tit. 6, § 18-1101(b) (2003).

16. See 2 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS* § 20.4 (3d ed. Supp. 2005).

17. DEL. CODE ANN. tit. 6, § 18-303(a) (2003).

of being a member or acting as a manager” of the LLC.<sup>18</sup>

Thus, according to the Act, an LLC is responsible for its own debts and obligations, and members and managers should have no liability for their activities relating to the LLC.<sup>19</sup> In regard to the latter, the Act explicitly contemplates that members and managers will have agency powers.<sup>20</sup> Pursuant to the Act, unless otherwise provided in the operating agreement, each of the members and the managers, if any, has the right to bind the LLC.<sup>21</sup> Given the Act’s broad limited liability provisions, the exercise of agency powers does not give rise to personal liability.<sup>22</sup>

### B. Separate Series

Consistent with the principle of flexibility embodied in the Act, an LLC may have multiple series of members, managers, or LLC interests, with “separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations.”<sup>23</sup> Further, to the extent set forth in the operating agreement, any such series may have a “separate business purpose or investment objective.”<sup>24</sup>

When an LLC has one or more series, and the LLC complies with certain record keeping, accounting, and notice requirements, the “debts, liabilities and obligations incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof.”<sup>25</sup>

In addition, unless otherwise provided in the operating agreement, “none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability

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18. *Id.*

19. *See generally id.*

20. *See id.* § 18-402.

21. *Id.*

22. Members and managers may agree to guarantee obligations of the LLC or provide collateral. *See id.* § 18-107. The above statutory grant of limited liability may be waived if the parties so choose. *See id.* § 18-303(b).

23. *Id.* § 18-215(a).

24. *Id.*

25. *Id.* § 18-215(b).

company generally or any other series thereof shall be enforceable against the assets of such series.”<sup>26</sup> The existence of separate series thus purports to protect the LLC’s other assets and other series’ assets from claims against a given series, as well as protect the assets of the various series from general claims against the LLC.<sup>27</sup>

#### IV. VEIL PIERCING—CORPORATIONS

The doctrine of veil piercing has its origins in corporate jurisprudence and usually arises in the corporate context.<sup>28</sup> Accordingly, it is important to review general principles of corporate veil piercing prior to any discussion of LLC veil piercing. Moreover, as more fully discussed below, there is a possibility that Delaware courts would apply some variation of corporate veil piercing to LLCs.

Corporate veil piercing most often applies in cases of (i) fraud; (ii) inadequate capitalization; (iii) failure to adhere to corporate formalities; and (iv) abuse of the corporate entity that results in complete dominance by the shareholder or shareholders.<sup>29</sup> Depending on the jurisdiction, alter ego, instrumentality, and like theories may be subsumed by or be synonymous with the veil piercing doctrine.<sup>30</sup>

Although Delaware has a well-developed body of corporate law, the law of veil piercing is relatively undeveloped.<sup>31</sup> It therefore is useful to consider the decisions of courts of other jurisdictions as well as those of Delaware. As an initial matter, a number of courts, including those in Delaware, have held that veil piercing is an equitable doctrine.<sup>32</sup>

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26. *Id.*

27. A veil piercing case involving a separate series could be analogous to certain types of piercing situations regarding parent and sister corporations. It is common to attempt to hold a parent corporation liable for the subsidiary corporation’s debts as the shareholder of the subsidiary. Another strategy, sometimes referred to as “triangular piercing,” involves an attempt to hold a sister corporation, under common ownership with the subsidiary but not itself a shareholder in the subsidiary, liable for the subsidiary’s debts. See Emily A. Lackey, Comment, *Piercing the Veil of Limited Liability in the Non-Corporate Setting*, 55 ARK. L. REV. 553, 562 (2002).

28. BISHOP & KLEINBERGER, *supra* note 4, § 6.03[1].

29. Cohen, *supra* note 2, at 456.

30. See Geyer v. Ingersoll Publ’ns Co., 621 A.2d 784, 793–94 (Del. Ch. 1992).

31. See John P. Glode, *Piercing the Corporate Veil in Wyoming—An Update*, 3 Wyo. L. Rev. 133, 143 (2003).

32. Floyd v. IRS, 151 F.3d 1295, 1300 (10th Cir. 1998); Johnson v. Exclusive

The threshold for veil piercing in terms of the severity of conduct has not received uniform treatment, but in all jurisdictions veil piercing is the exception rather than the rule.<sup>33</sup> As one Connecticut court put it, “A corporation’s structure will be disregarded, and corporate veil pierced, ‘only under exceptional circumstances such as where the corporation is a mere shell, serving no legitimate purpose, and used primarily as an intermediary to perpetuate fraud or promote injustice.’”<sup>34</sup>

In Massachusetts, for example, before a court may pierce the corporate veil, a plaintiff must meet a “very high standard.”<sup>35</sup> Under Massachusetts law, as interpreted by the First Circuit, specific factors that may come into play in a veil piercing analysis include, among other things, the following: (i) common ownership; (ii) pervasive control; (iii) confused intermingling of business activity; (iv) insufficient capitalization; (v) nonobservance of corporate formalities; (vi) nonpayment of dividends; (vii) insolvency of corporation at the time of transaction; (viii) siphoning of corporate funds by the dominant shareholders; (ix) nonfunctioning of officers and directors other than the shareholders; (x) absence of corporate records; (xi) use of the corporation for transactions of the dominant shareholders; and (xii) use of the corporation in promoting fraud.<sup>36</sup>

The courts have outlined the criteria for corporate veil piercing in various ways. Some have specifically enumerated the relevant factors as in the First Circuit decision above.<sup>37</sup> Similar formulations have been articulated in decisions under Illinois,<sup>38</sup> Kansas,<sup>39</sup> New York,<sup>40</sup> and

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Properties Unlimited, 720 A.2d 568, 572 (Me. 1998); *Terren v. Butler*, 597 A.2d 69, 72 (N.H. 1991); *Sonne v. Sacks*, 314 A.2d 194, 197 (Del. Super. 1973).

33. See *Johnson v. Koplovsky Foods, Inc.*, 5 F. Supp. 2d 48, 54 (D. Mass. 1998).

34. *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666, 672 (Conn. 1991) (quoting *Angelo Tomasso, Inc. v. Armor Constr. & Paving, Inc.*, 447 A.2d 406, 412 (1982)).

35. *Hiller Cranberry Prods., Inc. v. Koplovsky Foods, Inc.*, 2 F. Supp. 2d 157, 161 (D. Mass. 1998), *rev'd in part on other grounds*, 165 F.3d 1 (1st Cir. 1999). The seminal veil piercing case in Massachusetts is *My Bread Baking Co. v. Cumberland Farms, Inc.*, 233 N.E.2d 748 (Mass. 1968).

36. *Pepsi-Cola Metro. Bottling Co., Inc. v. Checkers, Inc.*, 754 F.2d 10, 14–16 (1st Cir. 1985).

37. *Id.*

38. See *Real Colors, Inc. v. Patel*, 39 F. Supp. 2d 978, 993 (N.D. Ill. 1999).

39. See *BioCore, Inc. v. Khosrowshahi*, 41 F. Supp. 2d 1214, 1228–29 (D. Kan. 1999).

Maine<sup>41</sup> law, among others.

Courts in certain other states, such as Delaware, have clearly recognized that piercing the corporate veil is appropriate under some circumstances.<sup>42</sup> Nevertheless, the courts have not necessarily been forthcoming in terms of defining those circumstances. Specifically, in Delaware, piercing may be effected only in the interest of justice.<sup>43</sup> It is understood that veil piercing is appropriate in cases of fraud.<sup>44</sup>

In addition to fraud in the strict sense, “something like fraud” may suffice.<sup>45</sup> Conduct that is equivalent to fraud, under Delaware law, generally must involve matters of contravention of law or contract, public wrong, or otherwise present compelling equitable considerations.<sup>46</sup> Moreover, on limited occasions, the Delaware courts have countenanced veil piercing in instances other than those strictly involving fraud or similar conduct.<sup>47</sup> Failure to adhere to formalities as well as similar improprieties thus potentially may serve as the basis for veil piercing. Likewise, Delaware courts may focus on alter ego or instrumentality theory in their veil piercing analyses.<sup>48</sup>

#### V. VEIL PIERCING—OTHER ENTITIES

Veil piercing issues can also arise with regard to limited partnerships (“LPs”) and limited liability partnerships (“LLPs”). Like LLCs, LPs and LLPs are unincorporated business entities.<sup>49</sup> In addition

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40. *See* *Liberty Mut. Ins. Co. v. Leroy Holding Co., Inc.* (In re Fort Ann Express, Inc.), 226 B.R. 746, 752 (N.D.N.Y. 1998).

41. *See* *Johnson v. Exclusive Props. Unlimited*, 720 A.2d 568, 571 (Me. 1998).

42. *See infra* notes 43–44.

43. *Pauley Petroleum Inc. v. Cont'l Oil Co.*, 239 A.2d 629, 633 (Del. 1968).

44. *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 793 (Del. Ch. 1992).

45. *Mobil Oil Corp. v. Linear Films, Inc.*, 718 F. Supp. 260, 268 (D. Del. 1989).

46. *Pauley Petroleum, Inc.*, 239 A.2d at 633.

47. *See, e.g., Harco Nat'l Ins. Co. v. Greens Farms, Inc.*, Civ. A. No. 1131, 1989 Del. Ch. LEXIS 114, at \*10 (Sept. 19, 1989).

48. *See* *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d at 793. Note that federal courts have developed their own alter ego standards under federal law, which may not be consistent with state law standards in a given case. *See, e.g., United States v. Golden Acres, Inc.*, 702 F. Supp. 1097, 1102-04 (D. Del. 1988) (“[A] court can pierce the corporate veil of an entity where there is fraud or where a subsidiary is in fact a mere instrumentality or alter ego of its owner.”).

49. In the interest of completeness, a variant of the limited liability partnership, the

to reviewing corporate veil piercing, it may be useful to consider veil piercing in the context of those entities as well.

As an initial matter, while general partnerships are unincorporated business entities, the concept of veil piercing is inapplicable.<sup>50</sup> In a general partnership, each of the partners already is liable for the obligations of the partnership.<sup>51</sup> There is no statutory grant of limited liability, and, therefore, no need for veil piercing.<sup>52</sup> With respect to LPs and LLPs, however, a closer examination is required.

In LPs, such as under the Delaware limited partnership statute,<sup>53</sup>

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limited liability limited partnership, should also receive mention. This variant only recently became available in certain jurisdictions and a discussion of veil piercing principles regarding such entity would not particularly further the discussion set forth in this article. That said, the analysis would be similar, if not identical, to a situation involving a limited liability partnership. In summary, partners with liability for debts of a limited partnership that elects to become a limited liability limited partnership have the same limitation on liability as partners in limited liability partnerships. Further, limited partners are protected from potential control liability. In Delaware, that much is clear. The Delaware limited partnership statute contains a provision that specifically negates limited partner control liability in limited liability limited partnerships. DEL. CODE ANN. tit. 6, § 17-214(c) (2003). Similarly, mention should be made of business trusts. There are few circumstances under which a trustee will be held liable to third parties. DEL. CODE ANN. tit. 12, § 3803(b) (2003). Essentially, the trustee serves pursuant to a contract and the arrangement is governed by trust and contract law. The beneficial owners have the same limitation on personal liability extended to stockholders of private corporations. *Id.* § 3803(a). Notwithstanding trustees' limited liability to third parties, trustees of business and other trusts remain liable to beneficiaries for any breach of contractual obligations, as well as any breach of fiduciary duty. *See, e.g.,* Fredric J. Bendremer, *Modern Portfolio Theory and International Investments Under the Uniform Prudent Investor Act*, 35 Real Prop., Prob. & Tr. J. 791 (2001) (discussing, among other things, the fiduciary duties of trustees in the investment management context).

50. Of course, the issue may arise regarding the veil of a corporation that is a partner in a general partnership.

51. Depending on the nature of the liability and the jurisdiction, partners' individual liability may be joint, or joint and several. In Delaware, liability is joint and several for all obligations. Delaware Revised Uniform Partnership Act, DEL. CODE ANN. tit. 6, § 15-306(a) (2003).

52. *See* Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n, 77 S.W.3d 487, 499 (Tex. App. 2002) (holding that the theory of alter ego, or piercing the corporate veil, is inapplicable to partnerships).

53. *See* Delaware Revised Uniform Limited Partnership Act, DEL. CODE ANN. tit. 6, §§ 17-101–17-1111 (2003).

general partners always remain fully liable for the partnership's obligations.<sup>54</sup> On the other hand, the liability of limited partners is limited to their investment.<sup>55</sup> There is an exception when a limited partner participates in control of the business.<sup>56</sup> When a limited partner participates in control, the limited partner risks losing limited liability unless the activities fall within a statutory safe harbor.<sup>57</sup> If the safe harbor applies, the activities are deemed not to constitute participation in control.<sup>58</sup> Such activities generally pertain to decision-making regarding certain fundamental changes in the organization or its business.<sup>59</sup> Thus, while not subject to veil piercing in the corporate sense, limited partners may be held liable for the partnership's obligations under some circumstances.

LLPs provide general partners with additional insulation against personal liability. The LLP is "conceptually and temporally related to LLCs but constitutes a legally distinct form of business organization with its own body of governing law."<sup>60</sup> Essentially, LLPs are general partnerships that register as LLPs. Statutes that permit such registration are characterized as either "full shield" or "partial shield."<sup>61</sup> In full shield jurisdictions, partners typically are protected from vicarious tort liability, as well as obligations and liabilities arising out of contracts.<sup>62</sup> Only vicarious tort liability for partners is eliminated in partial shield jurisdictions.<sup>63</sup>

Massachusetts, for example, is a full shield jurisdiction.<sup>64</sup> Delaware also is a full shield jurisdiction, but seemingly has broader statutory protections against personal liability. Pursuant to the Delaware general partnership statute,<sup>65</sup> which also addresses limited liability partnerships,

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54. *Id.* § 17-403(b).

55. *Id.* § 17-303(a).

56. *Id.*

57. *See id.* § 17-303(b)(1)-(10).

58. *Id.* § 17-303(b).

59. *Id.* § 17-303(b)(1)-(10).

60. Bendremer, *supra* note 10, at 43.

61. For a listing of full shield and partial shield states, see Table 3-1 in ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG AND RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT* (2001 ed.).

62. *Id.* at 30.

63. *Id.*

64. MASS. GEN. LAWS ch. 108A, § 15(2) (2003).

65. DEL. CODE ANN. tit. 6, §§ 15-101-15-1210 (2003).

partners are not liable for an “obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort or otherwise.”<sup>66</sup> Further, a “partner is not personally liable, directly or indirectly, by way of indemnification, contribution, assessment or otherwise, for such an obligation solely by reason of being or so acting as a partner.”<sup>67</sup>

Many statutes, such as the Massachusetts statute referred to above, explicitly provide that partners in a limited liability partnership remain liable for their own negligence, wrongful acts, or misconduct, as well for the actions of people under the partners’ control or supervision.<sup>68</sup> Although Delaware’s statute once contained such a provision, it no longer does so.<sup>69</sup> In any case, if personal liability exists under those types of provisions in a given case, veil piercing is unnecessary. Partners’ exposure is statutorily mandated. If the relevant conduct does not fall within that category, or if no such explicit exceptions appear in the statute, the issue of veil piercing may arise.

While some states have addressed veil piercing statutorily, and thus provided guidance as to the requisite circumstances for veil piercing in limited liability partnerships, most statutes are silent.<sup>70</sup> In the latter jurisdictions, many questions remain unanswered, as in the case of LLCs.

## VI. VEIL PIERCING—LLCS

Subject to certain exceptions,<sup>71</sup> the Act provides that the LLC itself shall be solely liable for its own debts and obligations, whether in contract or tort.<sup>72</sup> The Act further provides that members and managers

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66. *Id.* § 15-306(c).

67. *Id.*

68. *See, e.g.*, MASS. GEN. LAWS ch. 108A, §§ 15(3), 15(4) (2003).

69. DEL. CODE ANN. tit. 6, § 1513 (superceded July 12, 1999).

70. In Colorado, for example, corporate veil piercing principles are expressly made applicable to limited liability partnerships and limited liability limited partnerships. COLO. REV. STAT. § 7-64-1009(1) (2003).

71. Members and managers of LLCs have the potential for personal liability under several provisions of the Act. Such provisions include those relating to contributions to the LLC, as well as distributions prior to or upon dissolution. DEL. CODE ANN. tit. 6, §§ 18-502(c), 607(c) (2003).

72. *Id.* § 18-303(a).

shall have no liability solely by being a member or acting as a manager.<sup>73</sup> Taken literally, therefore, the statute suggests that members and managers of LLCs are fully insulated against personal liability. Veil piercing, if adopted by the courts of Delaware, would be a common law exception to that broad proposition.

#### A. National Trends

The Delaware courts, as mentioned above, have not ruled definitively on the applicability of veil piercing to LLCs.<sup>74</sup> Similarly, the law in other states, including as to whether corporate or some other body of law applies, is developing slowly.<sup>75</sup> It is noteworthy, however, that several LLC statutes explicitly state that the law of veil piercing applies to LLCs.<sup>76</sup> Some of the statutes make specific reference to corporate veil piercing principles.<sup>77</sup>

Where such a specific statutory provision exists, it is a fair assumption that courts will proceed accordingly.<sup>78</sup> Indeed, in those

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73. *Id.*

74. *See supra* note 31.

75. *See* 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 12.03 (1998).

76. *See generally infra* note 77.

77. *E.g.*, CAL. CORP. CODE § 17101 (2003); ME. REV. STAT. ANN. tit. 31, § 645(3) (2003); MINN. STAT. § 322B.303(2) (2003); FLA. STAT. ANN. § 608.701 (2003); GA. CODE ANN. § 14-11-314 (2003); WASH. REV. CODE § 25.15.060 (2003); WIS. STAT. § 183.0304(2) (2003); COLO. REV. STAT. § 7-80-107(1) (2003). Note that various statutes provide that the mere failure to follow formalities shall not be a basis for veil piercing for LLCs. Maine's statute, for example, so provides, though it appears subordinate to the section that authorizes corporate-type veil piercing; "Except as provided in subsection 3, the failure of a limited liability company to observe the usual limited liability company formalities or requirements relating to the exercise of its limited liability company powers or management of its business and affairs is not a ground for imposing personal liability on the members for liabilities of the limited liability company." ME. REV. STAT. ANN. tit. 31, § 645(2). Section 3 provides, "The exceptions under the common law to the limited liability of shareholders of a business corporation organized under the Maine Business Corporation Act and shareholders of a professional corporation organized under the Maine Professional Service Corporation Act apply to the limited liability of members of a limited liability company." *Id.* § 645(3).

78. *See* BISHOP & KLEINBERGER, *supra* note 4, § 6.03[2]; Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 18 (1997).

jurisdictions, courts have been more prone to apply corporate veil piercing to LLCs. Consequently, the law has a greater degree of certainty, with LLCs at greater risk of piercing. Presumably, the risk is akin to that associated with corporations.

A number of courts in jurisdictions whose statutes include piercing references, including Wisconsin,<sup>79</sup> Minnesota,<sup>80</sup> and Colorado,<sup>81</sup> have affirmed that veil piercing is applicable to LLCs. Even in such jurisdictions, applying principles of veil piercing is not an exact science. Rather, it often involves qualitative and subjective judgments, as well as the application of amorphous and broad principles. While there is greater certainty that veil piercing applies, uncertainty remains as to the outcome in a given case.

Courts recently have begun to address the applicability of veil piercing to LLCs in the absence of express statutory provisions. Courts in Connecticut,<sup>82</sup> New York,<sup>83</sup> Georgia,<sup>84</sup> and Wyoming<sup>85</sup> are among those that have confronted the question. In general, such courts have followed basic corporate veil piercing jurisprudence or analogous concepts. Several federal courts also have addressed LLC veil piercing under applicable state law. They most often have concluded that some type of veil piercing, usually corporate in nature, is applicable to LLCs.<sup>86</sup>

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79. *New Horizons Supply Coop. v. Haack*, No. 98-1865, 1999 Wisc. App. LEXIS 108, at \*8-9 (Jan. 28, 1999) (plaintiff failed to satisfy corporate veil piercing standards by showing the entity lacked separate existence and was a mere instrumentality used to evade an obligation, gain an unjust advantage, or commit an injustice).

80. *Tom Thumb Food Mkts., Inc. v. TLH Properties, LLC*, No. C9-98-1277, 1999 Minn. App. LEXIS 84, at \*8 (Jan. 26, 1999).

81. *Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997, 1004 (Colo. 1998).

82. *See Stone v. Hobby II Assocs., LLC*, No. CV000181620S, 2001 Conn. Super. LEXIS 1853, at \*25-32 (July 10, 2001). In a later case, a Connecticut appellate court affirmed the applicability of veil piercing principles to LLCs, but reversed a lower court's piercing decision as not satisfying applicable piercing standards. *KLM Indus., Inc. v. Tylutki*, 815 A.2d 688, 691-93 (Conn. App. Ct. 2003).

83. *See People v. Garban, LLC*, 1999 N.Y. Misc. LEXIS 390, at \*9-11, 77 Empl. Prac. Dec. (CCH) ¶46,371 (N.Y. Sup. Ct. 1999).

84. *See Yukon Partners, Inc. v. The Lodge Keeper Group, Inc.*, 572 S.E.2d 647, 651 (Ga. Ct. App. 2002).

85. *See Kaycee Land & Livestock v. Flahive*, 46 P.3d 323, 327-28 (Wyo. 2002).

86. *See, e.g., Hollowell v. Orleans Reg'l Hosp., C.A. No. 95-4029S*, 1998 U.S. Dist. LEXIS 8184, at \*27-31 (E.D. La. May 29, 1998), *aff'd*, 217 F.3d 379 (5th Cir. 2000) (holding that corporate veil piercing principles generally apply to LLCs, though

The above results are consistent with the views of commentators who have argued that veil piercing for LLCs should be similar if not identical to corporations.<sup>87</sup> In contrast, some other commentators have suggested that corporate veil piercing should apply, but with significant modifications to accommodate the different characteristics of LLCs.<sup>88</sup> While a number of recent cases have addressed veil piercing, the doctrine remains entirely unaddressed in many jurisdictions. Because of the novelty of LLCs nationally, the volume of jurisprudence on the topic is limited, even in jurisdictions in which courts have decided one or more veil piercing cases.

*B. Particular Provisions of the Act*

In addition to the provisions of the Act that expressly limit personal liability, which are critical to a veil piercing analysis, several other provisions may shed some light on how Delaware courts would proceed with their analysis. Specifically, section 18-1101 of the Act states, “The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.”<sup>89</sup>

The Act thus reflects a bias against common law doctrines that conflict with the Act’s provisions. One such doctrine arguably is veil piercing. Delaware courts are not known to stray far from the relevant statutory language.<sup>90</sup> In fact, statutory language often is the focal point for Delaware courts’ reasoning.<sup>91</sup>

The linguistic inquiry does not necessarily end there. Section 18-1104 of the Act states, “In any case not provided for in this chapter, the rules of law and equity, including the law merchant, shall govern.”<sup>92</sup> How a Delaware court would interpret and reconcile the foregoing

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failure to adhere to formalities may not suffice for veil piercing); *see also* Ditty v. Checkrite, Ltd., 973 F. Supp. 1320, 1335-36 (D. Utah 1997); *Sec. Investor Prot. Corp. v. R.D. Kushnir & Co.*, 274 B.R. 768, 775 (Bankr. N.D. Ill. 2002).

87. *See, e.g.*, Thompson, *supra* note 78, at 7.

88. *See, e.g.*, Steven C. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43 (1994).

89. DEL. CODE ANN. tit. 6, § 18-1101(a) (2003).

90. Cohen, *supra* note 2, at 477 (noting that Delaware courts take a formal approach to reading statutes and stay close to the literal meaning).

91. *Id.*

92. DEL. CODE ANN. tit. 6, § 18-1104 (2003).

provisions in a veil piercing case is an open question. Since veil piercing is an equitable doctrine, albeit one to be applied only under rare circumstances, courts could well find that veil piercing is consistent with the latter provision.

### C. Delaware Cases

As discussed above, the Delaware courts have applied the doctrine of veil piercing to shareholders of corporations, who have similar statutory protections against personal liability.<sup>93</sup> Those cases most often involved fraud. Several recent Delaware cases give an indication of the direction of LLC veil piercing in Delaware, though fall short of a definitive pronouncement on the issue.

In *Trustees of Village of Arden v. Unity Construction Co.*,<sup>94</sup> the plaintiffs claimed two Delaware LLCs were alter egos of each other.<sup>95</sup> The plaintiffs alleged that because the LLCs had a common principal, “there is a strong indication that [one of the LLCs] may have been acting as the mere instrumentality or alter ego of [the other LLC].”<sup>96</sup> According to the plaintiffs, the alleged alter ego relationship constituted grounds for disregarding the LLCs’ separate legal existence.<sup>97</sup>

The court was not persuaded that the plaintiffs made out a case of alter ego.<sup>98</sup> Notwithstanding the shortcomings of the plaintiffs’ case, the court endorsed LLC veil piercing as a conceptual matter.<sup>99</sup> In fact, the court made reference to a prior corporate veil piercing case, and quoted language from that case with approval: “A court can pierce the corporate veil of an entity where there is fraud or where a subsidiary is in fact a mere instrumentality or alter ego of its owner.”<sup>100</sup> With regard to the

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93. In interpreting the Act, if a court finds an absence of case law, the court may look to decisions interpreting similar provisions of the Delaware corporate and partnership statutes. *See, e.g.*, *Bond Purchase, LLC v. Patriot Tax Credit Props., LP*, 746 A.2d 842, 851 (Del. Ch. 1999).

94. C.A. No. 15025, 2000 Del. Ch. LEXIS 7 (Jan. 26, 2000).

95. *Id.* at \*11.

96. *Id.* (quoting Plaintiffs’ Opposition to Renewed Motion to Dismiss).

97. *Id.*

98. *Id.* at \*14.

99. *Id.* at \*12.

100. *Id.* (quoting *Geyer v. Ingersoll Publ’ns Co.*, 621 A.2d 784, 793 (Del. Ch. 1992)).

LLCs at issue, however, the court ruled that “similar ownership is not sufficient to justify disregarding their business forms.”<sup>101</sup> Finding no issues of material fact in dispute, the court granted partial summary judgment to the defendants.<sup>102</sup>

While the *Unity Construction* case did not go so far as to pierce the veil, it shows an inclination to do so if compelling circumstances present themselves. It is also noteworthy that the court made specific reference to a corporate veil piercing case. Nevertheless, the facts and holding of *Unity Construction* are limited. Therefore, it still remains to be seen how the Delaware courts ultimately will proceed.

The subsequent case of *Pepsi-Cola Metropolitan Bottling Company of Salisbury, Maryland v. Handy*<sup>103</sup> provides some additional guidance on the subject. *Handy* demonstrates that a Delaware LLC will not insulate an individual for misconduct. Particularly, the *Handy* court asked and answered the following rhetorical question: “[I]f a person makes material misrepresentations to induce a purchaser to purchase a parcel of land at a price far above fair market value, and thereafter forms an LLC to purchase and hold the land, can that person later claim that his status as an LLC member protects him from liability to the purchaser under § 18-303? I think not.”<sup>104</sup>

Like *Unity Construction*, the *Handy* court did not explicitly pierce the veil of the LLC. The court specifically stated that it did not need to consider the piercing issue in a strict sense.<sup>105</sup> Rather, consistent with Delaware courts’ predisposition to focus on precise statutory language, the court undertook a linguistic analysis of the limited liability provisions of the Act. As set forth above, section 18-303 of the Act provides that “no member or manager of a limited liability company shall be obligated personally for any such debt, obligation or liability of the limited liability company solely by reason of being a member or

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101. *Id.* at \*13. In addition to arguing that common ownership does not establish alter ego, the defendants claimed that any alter ego status was negated due to the existence of a construction management contract between the LLCs. *Id.* The court found that alter egos may have contracts between them, and thus the existence of such contract showed little. *Id.*

102. *Id.* at \*14.

103. C.A. No. 1973-S, 2000 Del. Ch. LEXIS 52 (Mar. 15, 2000).

104. *Id.* at \*11–12.

105. *Id.* at \*16–17.

acting as a manager of the limited liability company.”<sup>106</sup>

The court focused on whether the defendants were being sued “solely by reason of being a member” of the LLC, where the “claim is based upon fraudulent acts committed by the LLC members before the LLC was formed and took title to the [p]roperty.”<sup>107</sup> The court reasoned that while suits against members were barred if they were based solely on membership status, third parties may “recover from an LLC member on claims that do not arise ‘solely by reason of being a member or acting as a manager of the limited liability company.’”<sup>108</sup>

According to the court, since the “facts alleged in the complaint establish that the LLC was not formed (and the [p]roperty was not acquired by the LLC) until after the allegedly critical wrongful acts had been committed, it follows that the defendants could not have been acting ‘solely as members of the LLC when they committed those acts.’ Therefore, the defendants are not protected by § 18-303.”<sup>109</sup>

On the basis of the court’s linguistic and temporal analysis, the court concluded that the suit was proper.<sup>110</sup> In summary, members were being sued in an unprotected capacity and the veil need not be pierced for the plaintiff to state a cognizable claim.<sup>111</sup> The *Handy* case shows, at least arguably, that the court was sympathetic to the notion of veil piercing, but would only proceed with that remedy if left with no other choice.

In the case of *Somerville S Trust v. USV Partners, LLC*, a Delaware court again validated the alter ego doctrine in the context of LLCs.<sup>112</sup> Nevertheless, due to the nature of the action and the relief the plaintiff requested, the court did not actually proceed with piercing the LLC’s veil.<sup>113</sup> That result is reminiscent of the outcomes of both *Universal Construction* and *Handy*.

Specifically, in the *USV Partners* case, a plaintiff trust sought to compel access to the books and records of a Delaware LLC.<sup>114</sup> The

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106. DEL. CODE ANN. tit. 6, § 18-303(a) (2003).

107. See *Handy*, 2000 Del. Ch. LEXIS 52, at \*11.

108. *Id.* at \*16.

109. *Id.* at \*13 (footnote omitted).

110. *Id.* at 17.

111. *Id.* at \*16–17.

112. Civ. A. No. 19446-NC, 2002 Del. Ch. LEXIS 103 (Aug. 2, 2002).

113. *Id.* at \*11.

114. *Id.* at \*1.

plaintiff held a membership interest in the LLC, which in turn invested in certain convertible preferred stock in a publicly traded company, along with a warrant to purchase common stock in the company.<sup>115</sup> Without the consent of the plaintiff, which had made a series of contributions to the LLC, the LLC borrowed large amounts of funds and pledged shares in the public company as collateral, all in violation of the operating agreement.<sup>116</sup> In addition, the LLC, through its sole director, officer, and employee, allegedly made a number of misrepresentations to the plaintiff that induced the plaintiff to make additional investments in the LLC.<sup>117</sup>

The plaintiff sought to review certain books and records of the LLC to investigate the alleged wrongdoing and mismanagement, among other things, and to ascertain the value of its membership interest.<sup>118</sup> After the LLC refused, the plaintiff filed an action to compel the LLC to make its books and records available for inspection.<sup>119</sup> In its decision, the court noted that the purposes for the plaintiff's inspection were "reasonably related to the member's interest as a member of the limited liability company."<sup>120</sup> Therefore, the plaintiff had the right to inspect the books and records under the Act.<sup>121</sup>

With regard to veil piercing, one portion of the court's opinion is particularly relevant, relating to the alter ego doctrine. The plaintiff claimed that the LLC's principal mismanaged the LLC by failing to

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115. *Id.* at \*2.

116. *Id.* at \*4.

117. *Id.* at \*5. In addition, the LLC filed a Schedule 13D with the Securities and Exchange Commission, which contained false statements with regard to whether any consents or approvals were required for the pledge agreement. *Id.* The LLC also acted as syndicate manager for a venture capital investment in another company. In connection therewith, the LLC allegedly commingled funds, mismanaged various transfers of funds, and otherwise acted in a manner that raised questions regarding the location, disposition, and status of certain funds to which it was entrusted. *Id.* at \*6–8.

118. *Id.* at \*9.

119. *Id.* at \*1.

120. *Id.* at \*11–12 (quoting DEL. CODE ANN. tit. 6, § 18-305(a) (2003)). Assuming a member has a proper purpose, such member has the right to obtain various information from the LLC, including the LLC's business and financial condition, tax returns, identity of members and managers, and contributions of cash, property, and services, among other things. *Id.*

121. *Id.* at \*33–34.

comply with legal formalities while operating the business.<sup>122</sup> In effect, according to the court, the plaintiff argued that the principal used the LLC as his alter ego.<sup>123</sup>

The court agreed with the plaintiff's alter ego allegation. In fact, the court stated,

The defendants make no effort to rebut that claim, and I find independently that [the plaintiff's] evidence supporting that claim is credible, [the principal] testified that [the LLC] had no officers, directors, or employees, that [the LLC] had no office, and that [the LLC's] address was [the principal's] home address.<sup>124</sup>

The court further noted that the LLC's "documents were kept at [the LLC's office], at [the principal's] personal accountant's office, and at his home."<sup>125</sup>

Although the court found that the LLC indeed was the alter ego of its principal, that finding, in and of itself, does not constitute piercing the veil. Rather, it was only one of many grounds supporting the plaintiff's inspection demand. If the nature of the action had been different, the court's findings could have had greater significance and precedential value.<sup>126</sup> Instead, the decision strongly suggests that the alter ego doctrine is applicable to LLCs, but fails to include an actual finding of personal liability on that basis.

#### D. Commentary

Given that Delaware courts have yet to pierce the veil of an LLC, the status of veil piercing in Delaware is by definition uncertain.

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122. *Id.* at \*23.

123. *Id.*

124. *Id.* (footnote omitted).

125. *Id.* at \*23–24 (footnote omitted). The court went on to note that in a previous arbitration proceeding pertaining to an unrelated single-purpose entity operated by the same principal, the arbitrators found that the principal had improperly used assets to secure debts. *Id.* at \*24. The court observed that the arbitrators characterized the principal's conduct as a "pervasive disregard of corporate formalities, all of which is probative in supporting the conclusion that the [subject entities] were in fact merely alter egos of [the principal]." *Id.*

126. Of course, the court's findings could prove to have critical collateral estoppel effects in a future veil piercing claim by the plaintiff.

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Likewise, if the courts adopt veil piercing, it is not necessarily certain what type of veil piercing would apply. Based upon *Unity Construction*, *Handy*, and *USV Partners*, the courts are acutely aware of the issue.<sup>127</sup> While they seem sympathetic to the notion of veil piercing, in each case the courts found another legal basis to dispose of the action.

The court in *Unity Construction* was unequivocal in embracing veil piercing as a general concept, at least rhetorically. Moreover, it appears to have favored corporate veil piercing in light of the court's explicit reference to a corporate veil piercing case. It should be noted that there is a natural inclination to refer to corporate veil piercing cases. That is so because corporate veil piercing cases constitute the bulk, if not the entirety, of veil piercing law in Delaware. Thus, if the courts actually were to pierce the veil of an LLC, they could adopt some or all principles of corporate piercing. Alternatively, the courts still have the opportunity to develop a unique veil piercing jurisprudence for LLCs.

In *Handy*, the court used a linguistic and temporal analysis that essentially had the effect of veil piercing. The court focused on the wording of section 18-303 of the Act—"solely by reason of being a member"—and found both the language and the time of the alleged wrongful acts obviated the necessity of piercing the veil. Since the acts largely predated the LLC, and were not attributable to the member's conduct as a member per se, the court found the provision did not apply.

Of course, if the Delaware courts were so inclined, they could extend the reasoning of *Handy* to other member conduct, whether before, during, or after the formation of an LLC. That way, they could avoid explicitly incorporating veil piercing jurisprudence into the law of LLCs, yet obtain the same results. Any act for which liability should attach could be deemed outside the coverage of the limited liability provision. That approach, however, would be neither candid nor legally sound.

The *USV Partners* case, while not the strongest precedent for veil piercing, suggests the courts would proceed along more conventional lines. Like *Unity Construction*, the court clearly recognized the veil piercing concept in the context of LLCs. Actually piercing the veil admittedly was not among the appropriate forms of relief in the case. Instead, the court deemed the subject LLC the alter ego of its principal, and thereby recognized another compelling basis for the plaintiff's

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127. See *supra* notes 94, 103, and 112.

inspection demand.

The true test of the Delaware courts' willingness to pierce the veil will occur when there is no less dramatic remedy available. That has yet to happen. When it does, it will be interesting to review the court's reasoning, its interpretation of the limited liability provisions of the statute, its analysis of relevant precedent, and any views on related public policy. In addition, it will be particularly interesting to review any discussion of the Act's provisions regarding statutes in derogation of the common law and preservation of otherwise applicable rules of law and equity.<sup>128</sup> Further, the case could involve a separate series under the Act's unique provisions, which would lend itself to a novel analysis with potentially important economic implications.

In other jurisdictions, as discussed above, the trend is in favor of veil piercing.<sup>129</sup> Corporate-type veil piercing is the most common.<sup>130</sup> Importantly, however, not all corporate veil piercing principles necessarily apply to Delaware LLCs. Inadequate capitalization, a frequent basis for corporate veil piercing, is addressed by the Act, at least insofar as the Act prohibits distributions that render an LLC insolvent.<sup>131</sup> Failure to make required contributions, which can lead to inadequate capitalization, is also actionable under the Act itself.<sup>132</sup> In those instances, assuming a third party successfully enforces the relevant provisions, the remedy of veil piercing is unnecessary.

Moreover, the corporate formalities basis for veil piercing is largely inapplicable. The Act does not prescribe the formalities usually associated with corporations. One of the advantages of utilizing the LLC entity is precisely to avoid the burdens of such formalities.<sup>133</sup> It would be an ironic result if making use of one of the principal features of the Act led to liability.

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128. Although these provisions were not necessarily critical to the existing decisions, they may be of considerable importance in later cases.

129. RIBSTEIN AND KEATINGE, *supra* note 75, § 12.03.

130. *Id.*

131. *See* DEL. CODE ANN. tit. 6, § 18-607(a) (2003).

132. *See id.* § 18-502(c).

133. Arguably, there is a trend in favor of relaxing formalities to a degree even with corporations. *See* Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n, 77 S.W.3d 487, 500-501 (Tex. App. 2002) (holding that compliance with corporate formalities is no longer a factor in determining alter ego and thus is not evidence of alter ego). LLCs and their members are beneficiaries as well. *Id.*

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Despite the lack of perfect transferability of corporate veil piercing law, it is likely that Delaware courts would apply corporate veil piercing or some variation to LLCs. That assumes the courts affirmatively adopt veil piercing in the LLC context. Under corporate veil piercing doctrine, among other things, the use of an LLC to perpetrate fraud could serve as the basis for veil piercing. Similarly, commingling of assets, insolvency at the time of a transaction, ambiguity in identity, exploitation by dominant members, and the like could all serve as the basis for veil piercing. If an LLC is deemed an alter ego or mere instrumentality, that finding could be a rationale for veil piercing as well.

Corporate law would be most consistent with existing cases from other jurisdictions as well as scholarly commentary. The underlying rationale for limited liability for LLCs and corporations is fundamentally the same. In addition, while LLCs have some similarities to other entities—the Act in fact is modeled on Delaware’s limited partnership act—veil piercing law pertaining to other entities is generally nonexistent, undeveloped, or not transferable to LLCs. For this reason, there is a practical impetus to applying corporate veil piercing law: There are few, if any, alternatives.

As noted above, general partnership law has little bearing on LLC veil piercing because there is no veil or shield in the first instance. The applicability of limited partnership law also is doubtful. With certain exceptions, limited partnership law imposes liability on limited partners who participate in control of the business. In contrast to a limited partnership, one of the fundamental purposes of an LLC is to provide members with an opportunity to participate in management. The Act provides that no liability shall arise as a result.

With regard to limited liability partnerships, their characteristics are distinct and no justification exists for judicially incorporating one body of law into the other.<sup>134</sup> Further, the public has an interest in corporate veil piercing for LLCs. Ordinarily, no one in an LLC has personal liability. In general partnerships and limited partnerships, general partners remain liable for the entity’s obligations.

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134. Similarly, there appears to be no justification for applying to LLCs the law pertaining to business trusts, which are governed by trust and contract law. While LLCs and business trusts share some contractual characteristics, the law pertaining to business trusts is too discrete and particularized to apply to LLCs. That said, an operating agreement is a contract and the Act emphasizes the contractual nature of the undertaking. Thus, contract law cannot be entirely discounted.

Liability is broader for most limited liability partnerships as well, particularly in terms of the continuing liability for partners' own wrongs and in respect of supervisory liability. Moreover, in partial shield jurisdictions, partners remain liable for contractual obligations. Given the absence of personal liability, inadequate capitalization also is of greater concern with LLCs than with general partnerships, limited partnerships, and partial shield limited liability partnerships. Public policy thus favors the veil piercing remedy in general and corporate veil piercing in particular.

## VII. CONCLUSION

Limited liability is one of the principal characteristics of an LLC. That limited liability, however, is not necessarily absolute. The doctrine of veil piercing permits courts, under some circumstances, to disregard an entity's form and the protections from personal liability otherwise accorded to equity holders.

The Act does not address veil piercing specifically and the courts of Delaware have not ruled definitively on the issue. Nevertheless, based upon the Act, existing Delaware case law, the law of other jurisdictions, and scholarly commentary, there is a substantial likelihood the courts of Delaware would apply veil piercing to LLCs. In that regard, it is most likely such courts would apply corporate-type veil piercing or some variation thereof.