CHANGES TO FRCP 7.1 AND IMPACTS ON CORPORATE STRUCTURE

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The limited liability company is the mule of corporate structure—a hybrid between the oldest of corporate forms (the partnership) and the relatively modern innovation of the corporation. And just like a mule inherited certain characteristics, like its shorter mane, from the donkey and other characteristics, like its height, from the horse, so too has the limited liability company inherited certain characteristics, like tax treatment, from the partnership side of the family and certain other characteristics, like limited liability, from the corporation side of the family.

While the genetic mashing that led to the limited liability company has generally made it a favorite among corporate attorneys in a number of contexts like real estate and early-stage start-ups, one unfortunate characteristic the limited liability company inherited from the partnership side of the family is its treatment under Title 28, Section 1332 of the United States Code.

Like the rest of our federal government, federal courts enjoy limited, enumerated powers to hear certain cases listed in Article III, Section 2 of the United States Constitution. This "judicial power," as it's called, extends to "Controversies … between Citizens of different states." This is commonly referred to as "diversity jurisdiction."

Put differently, as long as you don't have citizens from the same state on either side of the "v" and there's at least $75,000 at issue (a statutory requirement Congress added), you can be in federal court regardless of the claims you have. Those claims don't have to be questions of federal law, and your case doesn't have to involve the United States, but you can still be in federal court. The question then becomes how courts determine the citizenship of "persons," like corporations, partnerships, and limited liability companies, that aren't people.

Long before the advent of the limited liability company, federal courts settled this question as to partnerships and corporations. In an 1844 case entitled *The Louisville,* *Cincinnati, and Charleston Railroad Company v. Letson*, the Supreme Court gave what would become the rule for determining the citizenship of a corporation—namely, a corporation is a citizen of both the state under the laws of which it was incorporated, *and* the state in which the corporation has its principal place of business.

But, in an 1889 case entitled *Chapman v. Barney*, the Supreme Court declined to extend that rule to partnerships. And thus, a critical distinction between the corporation and the partnership was born—while corporations would be citizens of, at most, two states in the Union for purposes of diversity jurisdiction, partnerships would be citizens of every state in which the individual partners were themselves citizens.

Then came the limited liability company. Born in Wyoming in 1977 at the behest of the Hamilton Brothers Oil Company, which wanted the limited liability protections that a corporation afforded, without the double taxation, the limited liability company lay mostly dormant for over a decade while the uncertainty of its tax treatment lingered. Then, in 1988, the IRS issued Revenue Ruling 88-76, which confirmed that limited liability companies would be taxed as partnerships notwithstanding the express limited liability protections afforded by state statutes (and despite the IRS's earlier efforts to tax them as corporations). Within three years, 18 states had adopted statutes allowing for the creation of limited liability companies, and the LLC craze of the 1990s was born.

Unsurprisingly, cases start popping up in federal trial courts near the end of the millennium raising the question of how the citizenship of limited liability companies would be determined for purposes of diversity jurisdiction. By 2003, in a case from the United States Court of Appeals for the District of Columbia entitled *Johnson-Brown v. 2200 M Street LLC*, the issue was settled—the LLC would get its citizenship test from the partnership side of the family and would be a citizen of every state in which its members are citizens.

Nevertheless, lawyers remained largely ignorant of this rule for many years, treating LLCs like corporations in federal court. But because courts at all levels—trial, appellate, and supreme—have a duty to ensure they have jurisdiction, this ignorance led to draconian and often costly chaos. Indeed, I remember a federal appellate judge expressing disappointment several years ago that one of the cases before her court would likely have to be dismissed for lack of jurisdiction because it appeared that members of the LLC on one side of the "v" were citizens of the same state as parties on the other side. Particularly disappointing to this jurist was the fact that the parties had likely spent upwards of a million dollars *each* on attorney fees, but the dismissal for lack of jurisdiction would force them to start their litigation all over, putting them back at square one.

In August of 2019, the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States proposed an amendment to the disclosure requirements found in Rule 7.1 of the Federal Rules of Civil Procedure. The proposed amendment added a requirement that every litigant must, as soon as they appear in federal court, file a disclosure statement advising the court of its citizenship for purposes of diversity jurisdiction. The comments from the committee made clear that this amendment was in direct response to lawyers' oversight regarding the citizenship of limited liability companies in federal court, and the fallout it created for litigants. After the required hearings on the amendment, it went into effect on December 1, 2022.

I first learned of the amendment last summer. Although we filed our case before the Rule 7.1 amendment went into effect, the federal court in my home state of Utah ordered my client and the other litigants in our case—all of which were LLCs—to make the required disclosures, and to make sure we did them properly, the court ordered us to disclose their *entire* ownership structure until we got to a corporation or an individual, at which point we had to disclose their citizenship.

As you might expect, the process of properly doing these disclosures was quite cumbersome. My client had a series of LLCs stacked on top of each other within its corporate structure, and one of those LLCs had given a small amount of equity to a dozen or so former employees as part of their compensation. It did not matter that those employees were three or four LLCs removed from my client; we had to reach out to every one of those former employees to ask about where they resided on the date we filed our lawsuit. That question understandably triggered a litany of questions from the former employees about the lawsuit, with many of them worried they were somehow implicated.

Ultimately, we got the information and made the disclosure, but I realized in the wake of that experience that every LLC-client wanting to file suit in federal court would have to undertake the same burden of ignoring every LLC up the chain of its corporate structure and figuring out the citizenship of every single individual or corporation that had any ownership, large or small—even those former employees who had no ongoing involvement with the company.

Since then, I have started advising clients to consider inserting a corporation where it makes sense within their corporate structure. While inserting a corporation does expose clients to the risk of double taxation that LLCs did away with, clients may still have the option to choose pass-through tax treatment under subchapter S of the Internal Revenue Code (such corporations being colloquially known as "S corporations"). Although an election under subchapter S comes with certain limitations, the most significant of which being that shareholders of an S corporation cannot be corporations, partnerships, or limited liability companies, these drawbacks must be weighed against the burden of reaching out to every individual anywhere in the ownership chain of an LLC to determine where they live, *every* time the company gets sued or is filing suit in federal court on the basis of diversity jurisdiction.

If a subchapter S election is still not workable for the client, I advise that the client consider inserting into its operating agreement (and the operating agreements of every other LLC up the chain of ownership) a requirement that the members advise the company of their citizenship for the purpose of diversity jurisdiction and require that members update this information as soon as it changes. Pragmatically, this comes with certain drawbacks since most members will not have this requirement in mind on an ongoing basis, but these drawbacks can be at least somewhat eliminated with regular reminders of the requirement, perhaps every year with delivery of their Schedules K-1.

While LLCs are still an advantageous corporate vehicle in a number of contexts, like all choices in life, they come with pros and cons. Although there's no "magic pill" to rid a client of all the cons, good lawyers will do well to make sure their clients are always thinking through their corporate structure with eyes wide open.

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