The Limited Liability Company: An Organizational Alternative for Small Business

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Comment

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I. INTRODUCTION

It is a matter of regret that unlike the business men on the continent of Europe, or even England, the American business man is, in the great majority of cases, practically forced today to choose between only two forms: the common law partnership and the corporation.¹

Colorado² and Kansas³ are the latest of four states to enact legislation permitting creation of a new business entity known as the Limited Liability Company ("LLC"), the other states being Florida⁴ and Wyoming⁵. The drafters of this legislation expressly intended to provide business planners with an alternative to corporations and partnerships.⁶ Typically, business planners focus on two considerations when deciding how to organize a business: The applicable nontax state law; and the income tax treatment of the business form chosen. For small business enterprises, the LLC possesses the best of both worlds because it combines the attractive limited liability feature of corporations with the income tax advantages of partnership classification. In addition, LLCs are more flexible than S corporations in accommodating various forms of ownership.⁷

While it is imperative that a business planner considering the LLC be familiarized with such advantages, a detailed discussion of the income tax advantages of partnership taxation is beyond the scope of this Comment.⁸ Rather, following this introduction, Part II acquaints the reader with the more prominent provisions of the existing LLC

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¹. Lewis, The Uniform Limited Partnership Act, 65 U. PA. L. REV. 715, 718 (1917). William Draper Lewis, Chairman of the committee of the National Conference of Commissioner on Uniform State Laws, was writing in support of the adoption of the Uniform Limited Partnership Act of which he was a draftsman.


⁶. See, e.g., Memorandum from Alson P. Martin to the Economic Development Committee (Feb. 28, 1990)(discussing proposed changes to Kansas H.B. 3064) [hereinafter Martin Memorandum].

⁷. To be eligible for S corporation treatment, a corporation may not have more than 35 shareholders, may not have shareholders who are nonresident aliens, corporations, or certain artificial entities, may not own a controlling interest in any other corporation, and may not have issued more than one class of stock (except for classes of common stock that differ only in voting rights.) See I.R.C. § 1361 (b)(1) (West 1990).

⁸. Historically, the disparity between corporate and individual income tax rates has been a consideration in selecting a business entity. However, recent changes in the federal tax rates have all but eliminated tax rates as a consideration. Similarly, legislative changes have removed many of the tax advantages bestowed on corporations in the area of fringe benefits. Despite these changes, corporations and partnerships still differ fundamentally because corporations pay taxes and partnerships do not. For a thorough analysis of that and other tax advantages of partnership classification, see A. WILLIS, J. PENNELL, & P. POSTELWAITE, PARTNERSHIP TAXATION (3d ed. 1981).
legislation. Next, Part III addresses the criteria used to establish partnership status for federal income tax purposes, and recent success in securing that status for LLCs. While the LLC’s pass-through taxation is virtually assured, concern persists about whether other states will respect its other chief characteristic, limited liability. Part IV analyzes past policy objections expressed by courts when denying other entities limited liability, and explains how subsequent changes in the laws of corporations and limited partnerships should render those objections obsolete as they pertain to LLCs.

II. THE LLC’S NONTAX STATE LAW PROVISIONS

The LLC is the most recent product of state experimentation with business forms. Michigan, New Jersey, Ohio and Pennsylvania have long provided for the formation of a “partnership association” or a “limited partnership association” which, like the LLC, combines limited liability with a partnership-like operational regime. However, numerous restrictions have burdened those business forms, limiting their appeal to investors. No comparable restrictions weaken the LLC. Rather, it is essentially a hybrid of existing state laws governing the close corporation and the limited partnership.

Because the LLC borrows most of its statutory language, business planners will benefit from a vast body of authority interpreting its provisions in their original corporate or partnership form. Where statutory language is unique, the language itself will obviously govern. The following discussion is a summary of the LLC’s statutory provisions, including those governing formation, management, finance and dissolution.

A. Formation

Formation of a LLC, like formation of a partnership, requires two or more persons. The definition of “persons” is generous and includes “individuals, general partnerships, limited partnerships, limited liability companies, corporations, trusts, business trusts, real

10. The primary defect appears to be a requirement that either the association’s principal place of business or its principal office be maintained in the state of organization. Accordingly, if the association maintains no, or only limited, operations in the state of organization, its members may lose the protection of limited liability. See Burke & Sessions, The Wyoming Limited Liability Company: An Alternative to Sub S and Limited Partnerships? 54 J. Tax’n 232, 233 (1982).
estate investment trusts, estates and other associations.”

That broad definition is a distinct advantage over the S Corporation which only allows United States citizens, resident aliens and certain estates and trusts to be shareholders. Moreover, S Corporations can only have thirty five shareholders.

Formation of a LLC can be a relatively simple matter. The organizers need only deliver articles of organization (“Articles”) that conform to the requirements of the act to the secretary of state. To conform, the Articles must contain information similar to that required in most states of corporations and limited partnerships, including:

1. The name of the LLC (which must contain some form of the words “limited liability company” or an abbreviation of those words).
2. The period of duration (which may not exceed 30 years from the date of the filing of the Articles).
3. The purpose for which the LLC is organized.
4. The address of its place of business in the state of organization, and the name and address of its initial registered agent in the state.
5. The total contributions (with a description and agreed value of property other than cash contributed), and the total additional contributions, if any, agreed to be made by all members (with the times or the events whereupon they will be made).

14. Id.
15. Historically, many of the provisions required to appear in the articles of incorporation were designed either to notify creditors of the risk they assumed by dealing with a limited liability enterprise, or to aid creditors in reaching corporate assets. Manne, Our Two Corporation Systems: Law and Economics, 53 VA. L. REV. 259, 268-69 (1967). For corporations those provisions cease to have any real importance. Id. at 268. However, they may provide some level of comfort to creditors unfamiliar with the LLC form of business at least while that business form is in its infancy. Furthermore, public disclosure gives the appearance of notice which may be helpful in sustaining the separate-entity status in foreign jurisdictions.
20. FLA. STAT. § 608.407(1)(e)(Supp. 1990); KAN. STAT. ANN. § 17-7607(a)(5)-(6) (Supp. 1990); WYO. STAT. § 17-15-107(a)(v)(1977). Colorado does not require such a disclosure in the Articles, but does require that that information be retained as
6. The right, if given, of the members to admit additional members (with the terms and conditions of admission).  

7. The right, if given, of the remaining members to continue the business following occurrence of one of the events causing dissolution.  

8. An election to be managed either by the members (with the names and addresses of the members) or by a manager or managers (with a statement that the company is to be managed by a manager or managers, and the names and addresses of the initial managers).

If the Articles conform to law, the secretary of state will file them and issue a certificate of organization.

The date of filing marks the beginning of the LLC’s legal existence, with the certificate of organization as conclusive evidence. Persons taking action on behalf of the LLC before that date, other than business incidental to organization or to obtaining subscriptions for or payment of contributions, may be personally liable because they lack the authority to bind the LLC.


25. COLO. REV. STAT. § 7-80-207 (Supp. 1990); FLA. STAT. § 608.409 (Supp. 1990); KAN. STAT. ANN. § 17-7609 (Supp. 1990); WYO. STAT. § 17-15-109 (1977). With the exception of Wyoming the statutes allow the date of formation to relate back to an earlier date. COLO. REV. STAT. § 7-80-207 (Supp. 1990)(date organizers deliver the Articles unless specified otherwise in the Articles); FLA. STAT. § 608.409(3)(a) (Supp. 1990)(date of subscription and acknowledgment if specified in Articles and if filed within 5 days, exclusive of legal holidays, of such date); KAN. STAT. ANN. § 17-7609(c)(1)(Supp. 1990)(date of subscription if specified in Articles and if filed within five days, exclusive of legal holidays, of such date). Moreover, those same states provide that organizers may delay the date of commencement up to 90 days of filing by express provision of the Articles. COLO. REV. STAT. § 7-80-207 (Supp. 1990); FLA. STAT. § 608.409(3)(b)(Supp. 1990); KAN. STAT. ANN. § 17-7609(c)(2)(Supp. 1990).


27. Of the four states with LLC statutes, only Colorado grants limited liability to
However, the simplicity of the organizational process reduces the probability of such an event.28

B. Management

Once organized, the LLC may conduct business for a broad range of purposes.29 The LLC is a legally distinct entity, with powers nearly

persons who act with an honest, but erroneous belief that they had authority to do so. Compare COLO. REV. STAT. § 7-80-105 (Supp. 1990) with FLA. STAT. § 608.437 (Supp. 1990) and KAN. STAT. ANN. § 17-7621 (Supp. 1990) and WYO. STAT. § 17-15-133 (1977). Because LLCs are so simple to organize, perhaps the drafters felt nothing short of filing the Articles should merit the privilege of limited liability. A possible reason for Colorado's departure from the other LLC statutes is that a Colorado LLC's legal existence may relate back to the date of delivery of the Articles to the secretary of state. See supra note 25. Perhaps the Colorado legislature felt that the "good faith belief" standard was necessary to avoid imposing too harsh a penalty on those who transacted business between the date of delivery and the date of filing.

Despite the clear language embodied in the stricter provisions, persons conducting preorganization activities may nevertheless be shielded from personal liability under certain circumstances. Their fate rests primarily on the degree to which the state courts choose to borrow interpretation from parallel corporation and partnership provisions, and the court's interpretation of those provisions in that jurisdiction. In states with similar corporation provisions courts have continued to apply the common law concepts of "de facto corporations, de jure corporations, and corporations by estoppel that provide protection against liability for preincorporation transactions." REVISED MODEL BUSINESS CORP. ACT § 2.04, Official Comment (1985). But see Robertson v. Levy, 197 A.2d 443, 449 (1964) (court interpreted District of Columbia code as rejecting de facto corporations and corporations by estoppel).

States adopting section 2.04 provide statutory relief by imposing personal liability only where persons purport to act for the corporation, "knowing there was no incorporation." REVISED MODEL BUSINESS CORP. ACT § 2.04 (1985). And of course, protection has long been accorded persons who contribute capital to a partnership erroneously believing a limited partnership certificate has been filed. UNIF. LTD. PARTNERSHIP ACT § 12 (1916); REVISED UNIF. LTD. PARTNERSHIP ACT § 3.04 (1985). Even if the courts read the stricter LLC provisions narrowly so as to impose personal liability, the members presumably could vote to ratify and accept the acts of the organizer who acted for the LLC before it was legally in existence.


29. Florida, Kansas, and Wyoming have adopted the "for any lawful purpose" language commonly found in state corporation acts. FLA. STAT. § 608.403 (Supp. 1990); KAN. STAT. ANN. § 17-7603 (Supp. 1990); WYO. STAT. § 17-15-103 (1977). However, those states have qualified that language by restricting LLCs from engaging in certain state regulated activities in the same manner that partnerships are restricted. Colorado, on the other hand, allows LLCs to operate "any business that a partnership with limited partners may lawfully conduct." COLO. REV. STAT. § 7-80-103 (Supp. 1990). That language is modeled after the Revised Uniform Limited Partnership Act (RULPA) and is intended to allow states to pro-
identical to a corporation. In addition to the Articles, members may adopt regulations (bylaws in Kansas) and an operating agreement to govern the internal affairs of the business. Typically, those documents will contain the same guidelines and information found in the bylaws of corporations or the operating agreement of a partnership (e.g., voting rights, notice requirements, management responsibilities, transfer of interest restrictions). Members have ultimate control over manage-

30. The difference in language would appear to be more form than substance.

30. COLO. REV. STAT. § 7-80-104 (Supp. 1990) provides that a limited liability company organized under its law may:

(a) Sue and be sued, complain and defend, and participate in administrative or other proceedings, in its name;
(b) Purchase, take, receive, lease or otherwise acquire, own, hold, improve, use, and otherwise deal in and with real or personal property, or an interest in it, wherever situated;
(c) Sell, convey, assign, encumber, mortgage, pledge, lease, exchange, transfer, and otherwise dispose of all or any part of its property and assets;
(d) Lend money to and otherwise assist its members and employees, except as otherwise dispose of all or any part of its property and assets;
(e) Purchase, take, receive, subscribe for or otherwise acquire, own, hold, vote, use, employ, sell, mortgage, lend, pledge, or otherwise dispose of, and otherwise use and deal in and with, shares or other interests in or obligations of other limited liability companies, domestic or foreign corporations, associations, general or limited partnerships, or individuals or direct or indirect obligations of the United States or of any government, state, territory, governmental district, or municipality or of any instrumentality of any of them;
(f) Make contracts and guarantees and incur liabilities, borrow money at such rates of interest as the limited liability company may determine, issue its notes, bonds, and other obligations, and secure any of its obligations by mortgage or pledge of all or any part of its property, franchises, and income;
(g) Lend money for its proper purposes, invest and reinvest its funds, and take and hold real property and personal property for the payment of funds so loaned or invested;
(h) Conduct its business, carry on its operations, and have and exercise the powers granted by this article in any state, territory, district, or possession of the United States or in any foreign country;
(i) Elect managers and appoint agents of the limited liability company and define their duties and fix their compensation;
(j) Make and alter operating agreements, not inconsistent with its articles of organization or with the laws of this state, for the administration and regulation of the affairs of the limited liability company;
(k) Indemnify a member or manager or former member or manager of the limited liability company . . . ;
(l) Cease its activities and surrender its certificate of organization;
(m) Have and exercise all powers necessary or convenient to effect any or all of the proposes for which the limited liability company is organized;
(n) Become a member of a general partnership, limited partnership, joint venture, or similar association or any other limited liability company.
ment through their power to elect managers, and by virtue of any control they choose to retain as members.

In addition, the members or managers may amend or repeal any existing provision of the regulations or operating agreement, or adopt new ones, provided the action taken is not inconsistent with state law or the Articles. Despite these similarities, the existing LLC statutes differ in the degree of state regulation, and accordingly in their resemblance to existing state corporation and partnership laws.

With the exception of the Colorado statute, each statute vests management in the members in proportion to their capital contributions, unless the members choose to have centralized management. Colorado mandates election of managers, but allows members to serve as managers in the same manner as under the other three statutes. A member who also manages may exercise control privileges similar to general partners of a limited partnership. However, unlike the general partner or the limited partner who participates in the control of the business, managing members of a LLC do not risk subjecting their personal assets to the claims of LLC creditors. Further discussion of limited liability is deferred until Part IV.

Aside from management by members in proportion to their capital contributions, each statute allows members to elect managers. Members have broad discretion over the election process, and the degree of authority delegated to managers, so long as they hold annual elections. As a means of assuring that ultimate control remains with

31. FLA. STAT. § 608.423 (Supp. 1990); KAN. STAT. ANN. § 17-7613 (Supp. 1990). Colorado achieves the same result by granting members the power to vote on "any matter" in similar fashion to section 302 of RULPA. COLO. REV. STAT. § 7-80-706 (Supp. 1990). See also REVISED UNIF. LTD. PARTNERSHIP ACT § 302 (1985).
32. Commentators have expressed concern over the lack of clarity of member voting rights, and advised that members adopt specific voting procedures in the regulations or operating agreement. August & Shaw, supra note 23, at 190.
33. FLA. STAT. § 608.422 (Supp. 1990); KAN. STAT. ANN. § 17-7612 (Supp. 1990); WYO. STAT. § 17-15-116 (1977). Those acts are silent, however, as to what percentage of votes is necessary to approve action, leaving that question to be answered in the regulations or operating agreement. The Colorado statute answers this question by providing for approval by a majority of members. COLO. REV. STAT. § 7-80-708 (Supp. 1990). However, it fails to address how voting power is to be distributed among members. See COLO. REV. STAT. § 7-80-706 (Supp. 1990).
34. A limited partner of a limited partnership organized under the RULPA is personally liable if "in addition to the exercise of his [or her] rights and powers as a limited partner, he [or she] participates in the control of the business." REVISED UNIF. LTD. PARTNERSHIP ACT § 303(a) (1985).
35. In particular, "The manager or managers ... hold the offices and have the responsibilities accorded to them by the members and set out in the operating agreement of the limited liability company." FLA. STAT. § 608.422 (Supp. 1990); KAN. STAT. ANN. § 17-7612 (Supp. 1990); WYO. STAT. § 17-15-116 (1977).
members, the Florida and Kansas statutes provide that members may repeal or alter any regulation or bylaw adopted by the managers, and adopt new regulations or bylaws. Moreover, members in those states may forbid managers from altering, amending, or repealing any regulations or bylaws adopted by the members. By contrast, the Wyoming statute leaves such details to be worked out by the members in the operating agreement. That contractual, rather than regulatory, approach closely resembles the traditional operational regime of the partnership, and, in modern times, possibly of the close corporation.

More closely aligned with general corporation laws, the Colorado and Kansas statutes require that management respect certain operational rules, including rules governing the meetings of members, notice of such meetings, and member voting. Colorado further regulates the relationship between members and managers in the following manner:

(1) members must elect and fix the number of managers;
(2) election of managers is by a majority vote;

39. See, e.g., UNIF. PARTNERSHIP ACT § 18 (1914) ("The rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them, by the following rules... ") (emphasis added).
40. See, e.g., REVISED MODEL BUSINESS CORP. ACT § 8.01(b)(1985) ("The business and affairs of the corporation [shall be] managed under the direction of the board of directors, subject to any limitation set forth in the articles of incorporation.") For a recent discussion of the contractual theory of corporations, see Butler, The Contractual Theory of the Corporation, 11 GEO. MASON L. REV. 99 (1989).
42. COLO. REV. STAT. § 7-80-709-10 (Supp. 1990); KAN. STAT. ANN. § 17-7613 (Supp. 1990).
44. COLO. REV. STAT. §§ 7-80-401, -402(1)(Supp. 1990). That requirement appears to be ill-advised when compared to close corporation statutes which have recognized that in the close corporation setting "management and ownership are substantially identical," Israels, The Close Corporation and the Law, CORNELL L. Q. 488, and have allowed shareholders to opt out of the traditional board of directors management scheme. See, e.g., REVISED MODEL BUSINESS CORP. ACT, CLOSE CORP. SUPP. § 21 (1985).

Unlike Colorado, Florida, Kansas, and Wyoming give members the option of electing managers. FLA. STAT. § 608.422 (Supp. 1990); KAN. STAT. ANN. § 17-7612 (Supp. 1990); WYO. STAT. § 17-15-116 (1977). Kansas, however, mandates the selection of a president and secretary at the annual meeting of the members, whether or not a manager or managers is or are elected. KAN. STAT. ANN. § 17-7613 (Supp. 1990). The drafters wanted to "provide a mechanism for creating a hierarchy or division of authority among the managers." Martin Memorandum, supra note 6.
managers owe members a statutory duty of care;\(^4\)
(4) members may remove a manager with or without cause by a majority vote of the members (members can specify the manner of removal in the operating agreement);\(^4\)
(5) managers may fill a manager vacancy by majority vote of the remaining managers, and that person will serve the unexpired term of his predecessor;\(^4\)
(6) any manager's position created by an increased number of managers must be filled by written agreement of a majority of managers then in office or by election at an annual meeting of the members;\(^4\)
(7) managers have the sole power to execute instruments and documents providing for the acquisition, mortgage, or disposition of property of the LLC;\(^4\)
(8) except as otherwise provided by the state law, the Articles, or the operating agreement, managers have the sole power to contract for a debt or liability by or on behalf of the LLC.\(^5\)

Proponents of increased regulation typically argue that it avoids problems if a passive investor lacks full cognition and volition about the risks and benefits of the managers' activities.\(^5\) However, the LLC

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\(^6\) COLO. REV. STAT. § 7-80-404 (Supp. 1990).

\(^7\) Id.

\(^8\) COLO. REV. STAT. § 7-80-403 (Supp. 1990). Florida, Kansas and Wyoming grant managers the same power if the members chose to have centralized management. FLA. STAT. § 608.425 (Supp. 1990); KAN. STAT. ANN. § 17-7614 (Supp. 1990); WYO. STAT. § 17-15-118 (1977). Those provisions create legal authority in managers, in addition to their apparent authority already provided by the general rules of agency. The drafters intended to instill confidence in third parties entering into the specified business transactions with managers. See Comment, THE LIMITED LIABILITY COMPANY ACT, 11 FLA. ST. L. REV. 386, 392 (1983).

\(^9\) COLO. REV. STAT. § 7-80-407 (Supp. 1990). Because this provision is subject to exceptions, it will effectively operate as a default rule. In Florida and Wyoming, where centralized management is optional, any member can bind the LLC. However, if managers are elected then they have binding power. FLA. STAT. § 608.424 (Supp. 1990); WYO. STAT. § 17-15-117 (1977). By contrast, Kansas requires that all written contracts of whatever type be signed by the president and secretary, or any other officer or person designated at a properly-called meeting of the members. KAN. STAT. ANN. § 17-7613 (Supp. 1990). The purpose of this requirement is to eliminate uncertainty about who can bind the LLC. Martin Memorandum, supra note 6. The reasoning behind the change is that "no one person should be able to obligate the entire entity," a fact immediately distinguishing an LLC from a partnership. Id.

\(^10\) The Colorado statute offers further protection to the passive investor by allowing access to certain basic LLC documents and information, including a current list of the names and addresses of all members and managers, a copy of the Articles and copies of income tax returns. COLO. REV. STAT. § 7-80-411 (Supp. 1990). In addition, members are entitled to a formal accounting "whenever circumstances render it just and reasonable." Id.
is ill-suited to serve the passive investor.\textsuperscript{53} The passive investor usually demands the maximum possible freedom to dispose of her interest.\textsuperscript{54} However, LLCs require consent of all members before all of the attributes of ownership may be transferred,\textsuperscript{55} and therefore inhibit formation of an efficient market for sale of ownership interests.\textsuperscript{56}

While the Colorado LLC does not offer marketability, neither does it offer liquidity. Absent forcing dissolution,\textsuperscript{57} a member's right to return of capital is severely limited. In addition to being limited to distributions that do not impair the firm's solvency, a member's right to a distribution is conditioned on a contingent obligation to repay, similar to partners of a limited partnership.\textsuperscript{58} A firm's ability to repay its creditors is dependent not only on its resources available at the time credit is extended, but also by its subsequent use of those resources and ability to generate new resources. In order to adequately assess these contingencies, an investor would have to monitor the entity's business activities, a practical impossibility for the passive investor. In short, the LLC is incapable of satisfying the passive investor, making the increased protection offered by mandatory operational procedures illusory.\textsuperscript{59}

On the other hand, a consequence of decreased state regulation is that the courts must pay greater attention to the duties owed by members to each other, and by managers to members. Because there will

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53. Edward J. Roche, Jr., a professor at the University of Denver College of Law and Graduate Tax Program, chaired the group which drafted the Colorado LLC act. Professor Roche indicated that the increased regulation adopted by the Colorado act is not the result of considerations of the passive investor. Rather, it was intended to protect creditors and others doing business with the LLC. Telephone Interview with Professor Edward J. Roche (January 25, 1991).

54. Hamill, \textit{The Limited Liability Company: A Possible Choice for Doing Business?}, 41 FLA. L. REV. 721, 747 (1989). An inability to transfer ownership interests will likely deter investment in LLCs despite the attractiveness of limited liability because, while limited liability protects investors from the risk of insolvency, liquidity or marketability of ownership interest is perhaps the most important consideration for investors when the entity is not threatened by bankruptcy. Manne, \textit{supra} note 15, at 264.

55. \textit{See infra} note 80, and accompanying text.

56. \textit{See infra} section III.D. While a member may transfer her right to share in LLC profits without consent of the other members, Hamill cautions against reliance on free transferability of interests to assure partnership income tax status for LLCs with many passive investors. \textit{See} Hamill, \textit{supra} note 54, at 747. In such situations, the Service could view the right to transfer a mere economic interest as free transferability of interest.

57. \textit{See infra} section II.D.

58. REVISED. UNIF. LTD. PARTNERSHIP ACT § 608 (1985).

59. Hamill makes the point more forcefully stating: "The LLC should never be chosen for ventures traditionally conducted in large limited partnerships in which the business includes many limited partners that do not meet or communicate regularly and in some cases are unaware of each other's identity." Hamill, \textit{supra} note 54, at 747.
\end{flushleft}
be no ready market for members to sell their interests, there will accordingly be no barometer to reflect member dissatisfaction with management decisions. Furthermore, managing members may attempt to freeze out non-managing members with methods developed by shareholders of close corporations.  

For these reasons it makes little sense to adopt the hands-off approach of the "business judgment rule," applied principally to decisions of directors of public corporations. The better rule would be to scrutinize the decisions of managers and members with the standard of utmost good faith and loyalty often used in both the partnership and close corporation settings.

C. Finance

None of the existing LLC statutes create unique financing provisions. Florida, Kansas and Wyoming each model their provisions after the Uniform Limited Partnership Act (ULPA); Colorado simply tracks the Revised Uniform Limited Partnership Act (RULPA). Both courses have the obvious advantage of avoiding much of the uncertainty of judicial interpretation. As one commentator pointed out: "Its [the LLC's] major disadvantage is its youth." Arguably then, the closer the statutory language resembles existing provisions, the more familiar and attractive the LLC will be to investors.

As a result of following the RULPA rather than the ULPA, the Colorado statute's finance provisions differ somewhat from those of the other three states. One such difference is immediately evident in the forms of contributions available to members. Unlike the Florida, Kansas and Wyoming statutes which limit member contributions to cash or other personal property, the Colorado statute also allows members to contribute services rendered or an obligation to contribute cash, property or services. Given that most LLCs will be small

60. Of course, the LLC's partnership-like dissolution provisions greatly diminish the threat of a freeze-out. See infra Part II. Section D.
62. Comment, supra note 50, at 405.

At first glance, the opportunity to contribute services appears to give investors added flexibility. The advantage is more perceived than real, however, because undesirable tax consequences will likely deter members from exercising this option. See Hamill, supra note 54, at 742 n.137.
businesses, the Colorado approach is preferable. Typically, small businesses consist of a few entrepreneurs, each with some specialized function to perform. They do not associate simply to amass capital, but rather to combine talents. An individual contributing organizational ability or some other specialized skill may be as valuable, or more valuable, to the firm as one contributing capital. Statutory provisions should reflect that reality and provide flexibility to participants.

Each of the statutes recognizes the need for flexibility when it comes to return on investment. Members may allocate and distribute profits in any manner they see fit, so long as the distribution does not leave the LLC insolvent. When losses are incurred, the members enjoy the favorable loss deduction rules of partnership taxation. Partners may deduct their share of partnership losses to the extent of their basis in the partnership, which is increased by their share of the partnership's non-recourse liabilities. Furthermore, because members have limited liability all LLC liabilities are non-recourse, provided that no member assumes or guarantees a LLC debt. Consequently, members are allowed to increase their basis (and not find their loss deduction limited under section 704(d)) even though they bear no risk of economic loss. That feature is perhaps the LLC's strongest advantage over the S corporation which offers shareholders no comparable means to increase their income tax basis.

Another unique feature of the Colorado statute is its interim distribution provision. That provision entitles members to withdraw a por-

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67. Members who wish to contribute services should take notice that Subchapter K treats a partner's contribution of services as a taxable event, unlike contributions of property. I.R.C. § 721 (West 1986).
70. See I.R.C. § 704(d)(West 1986).
tion of their capital contribution, via a provision in the operating agreement, without the onerous notice requirements of the other acts.\textsuperscript{73} Under the Florida, Kansas, and Wyoming statutes, unless the Articles authorize the withdrawal,\textsuperscript{74} or the other members consent by amending the Articles,\textsuperscript{75} a member can only withdraw his capital if there is no stated time of dissolution in the Articles, and if that member gives six months notice in writing to the other members.\textsuperscript{76} Colorado's omission of those requirements may improve the timeliness of distributions, but it by no means places members on equal footing with shareholders of corporations in terms of their ability to divest. Unlike shareholders, members who successfully withdraw contributions are liable to the LLC for the discharge of creditors who extended credit or whose claims arose before the withdrawal.\textsuperscript{77} The harshness of that and the other distributional limitations mentioned earlier is exacerbated by restrictions placed on transferability of interests.

A member's interest is considered to be personal property,\textsuperscript{78} and transferable only in the manner provided for in the operating agreement.\textsuperscript{79} In addition, if the other members refuse to approve the transfer by unanimous consent, the transferee obtains no right to participate in the management of the business and affairs of the LLC or to become a member.\textsuperscript{80} The transferee is only entitled to receive the transferor's share in the profits or return of contributions.\textsuperscript{81} Unlike partners of a limited partnership,\textsuperscript{82} members of a LLC may not remove the transferability restriction by agreement. However, the restrictions are not without justification.

One reason for such a strict rule is to insure some measure of certainty that the LLC will qualify for partnership income tax classifica-

\begin{itemize}
\item \textsuperscript{73} COLO. REV. STAT. § 7-80-601 (Supp. 1990); FLA. STAT. § 608.426 (Supp. 1990); KAN. STAT. ANN. § 17-7615 (Supp. 1990); WYO. STAT. § 17-15-119 (1977).
\item \textsuperscript{75} FLA. STAT. § 608.427(1)(b)(Supp. 1990); KAN. STAT. ANN. § 17-7616(a)(2) and (3) (Supp. 1990); WYO. STAT. § 17-15-120(a)(ii)(1977).
\item \textsuperscript{77} COLO. REV. STAT. § 7-80-607(1) (Supp. 1990)(limited to a period of six years); FLA. STAT. § 608.435(4)(Supp. 1990); KAN. STAT. ANN. § 17-7619(d)(Supp. 1990); WYO. STAT. § 17-15-121(d)(1977).
\item \textsuperscript{78} COLO. REV. STAT. § 7-80-702(1)(Supp. 1990); FLA. STAT. § 608.431 (Supp. 1990); KAN. STAT. ANN. § 17-7618 (Supp. 1990); WYO. STAT. § 17-15-122 (1977).
\item \textsuperscript{79} COLO. REV. STAT. § 7-80-702 (Supp. 1990); FLA. STAT. § 608.431 (Supp. 1990); KAN. STAT. ANN. § 17-7618 (Supp. 1990); WYO. STAT. § 17-15-122 (1977).
\item \textsuperscript{80} COLO. REV. STAT. § 7-80-702(1)(Supp. 1990); FLA. STAT. § 608.432 (Supp. 1990); KAN. STAT. ANN. § 17-7618 (Supp. 1990); WYO. STAT. § 17-15-122 (1977).
\item \textsuperscript{81} COLO. REV. STAT. § 7-80-702(1)(Supp. 1990); FLA. STAT. § 608.432 (Supp. 1990); KAN. STAT. ANN. § 17-7618 (Supp. 1990); WYO. STAT. § 17-15-122 (1977).
\item \textsuperscript{82} REVISED UNIF. LTD. PARTNERSHIP ACT § 704(a)(1985).
\end{itemize}
Not only may transferability restrictions be necessary for LLCs if they are to obtain partnership income tax status, they will actually be preferable for most small businesses. Participants in a small business are genuinely interested in knowing and controlling the identity of other participants. Indeed, shareholders of close corporations often place restrictions on share transferability when statutes impose none. In that light, restricting transferability can be seen as simply an adaptation to business practice.

D. Dissolution

Similar to businesses organized under the UPA and RULPA, a LLC dissolves when any of the following events occur:

1. When the period fixed for the duration of the LLC expires;
2. By the unanimous written agreement of all members; or
3. Upon the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member or the occurrence of any other event which terminates the continued membership of a member in the LLC, unless the business is continued by consent of all the remaining members under a right to do so stated in the Articles.

In addition to the above language, the statutes of Florida and Kansas allow members to provide for a self-executing "right to continue" the business by including such a provision in the Articles. That provision effectively eliminates the threat of dissolution following occurrence of one of the stated events, even if all the remaining members refuse to consent to continue the business. A creditor who reviewed an LLC's Articles prior to extending credit to the LLC might look with favor on a "right to continue" provision. However, extended continuity of life carries with it two different problems. It adds to the difficulties that members wishing to withdraw their interests must
bear.\textsuperscript{91} But more importantly extended continuity of life might have adverse consequences on the LLC's ability to obtain partnership income tax status.\textsuperscript{92}

If no "right to continue" is present and one of the stated dissolution-causing events has transpired, the LLC must execute a statement of intent to dissolve. After the secretary of state files the statement of intent to dissolve,\textsuperscript{93} the LLC must cease operations, except activities necessary to wind up its business.\textsuperscript{94} However, similar to corporation law,\textsuperscript{95} the state does not extinguish the LLC as a separate entity until the secretary of state receives and files articles of dissolution.\textsuperscript{96} Before articles of dissolution can be executed the LLC must settle its accounts by distributing assets in the following manner: first to creditors, next to members for their share of profits and other compensation by way of income on their contributions, and finally to members for return of capital contributions.\textsuperscript{97}

### III. BASIS FOR OBTAINING PARTNERSHIP CLASSIFICATION FOR FEDERAL INCOME TAX PURPOSES

One of the principal advantages of the LLC is that it offers its members pass-through income taxation. However, before an LLC can obtain the benefits of pass-through income taxation it must first achieve partnership classification. Until recently, uncertainty in this area had deterred investors from choosing the LLC as a business form. However, recent favorable rulings are sure to increase the rate of filings in the states with LLC legislation. Before those rulings can be understood, the reader first must become familiar with the criteria used for classifying entities as partnerships for federal income tax purposes.

The Internal Revenue Service (the "Service") classifies organizations as either associations\textsuperscript{98} (which are taxable as corporations), par-

\textsuperscript{91} See supra section II.C.  
\textsuperscript{92} See supra section III.A.  
\textsuperscript{95} See Revised Model Business Corp. Act § 14.03 (1985).  
\textsuperscript{98} Treas. Reg. § 301.7701-3(a)(as amended in 1983). The definition of an association is the principle applied to Morrissey v. Commissioner, 296 U.S. 344 (1935), and
nishments or trusts.99 Specifically, the term "partnership" for federal income tax purposes is much broader than typical statutory definitions,100 and may include 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 within the meaning of the [Code]."102

An organization will be taxed as a partnership if it is has more characteristics of a partnership than of a corporation.103 In applying that rule, commonly known as the "resemblance test,"104 the Service has identified six characteristics possessed by corporations: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests.105 However, because partnerships and corporations both have associates and an objective to carry on business and divide the gains therefrom, the Treasury Regulations provide that only the remaining four characteristics will be considered when determining partnership classification.106

includes entities resembling corporations although they are not formally organized as such.

100. Section 6 of the UNIFORM PARTNERSHIP ACT provides:
      (1) A partnership is an association of two or more persons to carry on as co-owners of a business for profit.
      (2) But any association formed under any other statute of this state, or any statute adopted by authority, other than the authority of this state, is not a partnership under this act, unless such association would have been a partnership in this state prior to the adoption of this act; but this act shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith.

UNIF. PARTNERSHIP ACT § 6 (1914).

105. Treas. Reg. § 301.7701-2(a)(1)(as amended in 1983). These characteristics were first ennumerated in Morrissey v. Commissioner, 296 U.S. 344 (1935). In Morrissey, the petitioners were trustees of an express trust created for the development of a golf course and the sale and rental of attached land. The trustees possessed broad powers of management and control, liability was limited to trust property, beneficial interests were freely transferable and the death of an owner of a beneficial interest did not terminate the trust. In holding the trust taxable as an association, the Court set out its six characteristics test whereby an organization which resembled a corporation more closely than any other type of entity would be classified as an association for federal tax purposes. See also Zuckman v. United States, 524 F.2d 729, 733 (1975).
Specifically, an organization will be taxed as a partnership if it lacks two of those four remaining corporate characteristics. In making its determination, the Service must take each into account, and give them equal weight. Further, the Service must consider all the facts and circumstances of a particular case, and must apply state law in determining whether these characteristics exist.

In addition to the substantive rules for partnership classification, the Service has set out certain criteria which must be met before it will consider a ruling request on partnership classification. Because that pronouncement covers both organizations formed as partnerships and others seeking partnership classification, an LLC must meet its requirements before the Service will consider a ruling request. The following discussion analyzes the requirements of that Revenue Procedure in the context of the four corporate characteristics identified in the Treasury Regulations.

107. Id.
110. Id.
111. The Treasury expressly provides that although it makes its own classification, "local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met." Treas. Reg. § 301.7701-1(c)(as amended in 1977). The Treasury Regulations add an example where a group of doctors agreed that neither the death, insanity, bankruptcy, retirement, resignation, nor expulsion of a member would cause the dissolution of the organization. The organization lacked continuity of life, however, because local law mandated that a member who withdraws has the power to dissolve the organization. Treas. Reg. § 301.7701-2(g) Example 2 (as amended in 1983).
113. Id.
114. In addition to the requirements tied to the four classification criteria, Revenue Procedure 89-12 imposes two preconditions on the minimum participation of general partners in a limited partnership. If neither of these are satisfied, the Service will not consider a ruling request for partnership classification. First, general partners must collectively own at least a one percent (1%) interest "in each material item of partnership income, gain, loss, deduction, or credit" if total contributions are not greater than $50 million. Rev. Proc. 89-12, 1989-1 C.B. 798 § 4.01. In the unlikely event that contributions exceed that amount, the percentage is reduced by the ratio of $50 million divided by total contributions. Id. at § 4.02.

Second, the general partners must either: (1) maintain minimum capital of the lesser of 1 percent of total positive capital or $500,000 or (2) at least one general partner must have contributed or will contribute substantial services for which guaranteed payment is not required. Id. at § 4.03. Partners contributing substantial services must also agree to contribute upon dissolution and termination the lesser of: any deficit in their capital balance or the excess of 1.01 percent of the limited partners total capital contributions over the previous capital contributions by the general partners. Id. at § 4.04.
A. Continuity of Life

The first corporate characteristic described in the Treasury Regulations is continuity of life. An organization lacks continuity of life if it dissolves upon the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member. The Treasury Regulations specifically recognize that business entities organized under the UPA or the RULPA will always lack the corporate characteristic of continuity of life. Accordingly, because the dissolution provisions in the existing LLC acts are modeled after the UPA, most LLC's will automatically lack continuity of life.

The Service added support for that conclusion in Revenue Ruling 88-76. There, the Service ruled that a Wyoming LLC lacked continuity of life because it dissolved following the "death, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event that terminate[d] the continued membership of a member of the company." The Service so held despite the ability of the remaining members to continue the business, if they so agreed. This ruling is consistent with Treasury Regulation Section 301.7701-2(b)(2), which provides that an organization lacks continuity of life if under local law the death or withdrawal of any member causes the organization to dissolve, notwithstanding the privilege afforded its members to continue the business by consent of the remaining members. Apparently, the Treasury believes that the prospect of the remaining members unanimously consenting to continue the business following technical dissolution is too remote to be compared to a corporation's unlimited life.

A recent Private Letter Ruling illustrates the importance of the

116. Dissolution is defined as "an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law." Treas. Reg. § 301.7701-2(b)(2)(as amended in 1983)(emphasis added).
118. The Treasury Regulations refer to the Uniform Limited Partnership Act, but add that any references to that act apply equally to the RULPA. Treas. Reg. § 301.7701-2(a)(5)(as amended in 1983).
121. See supra section II.D.
122. See WYO. STAT. § 17-15-123(a)(iii)(1977). Generally, if the continued existence of the entity is contingent on some stated event, it is unlikely that the entity has continuity of life within the meaning of the Treasury Regulations. See, e.g., Larson v. Comm'r, 66 T.C. 159 (1976). In Larson, a limited partnership agreement called for the partnership to terminate upon the "adjudication of bankruptcy of the General Partner," id. at 175, but allowed the limited partners to elect a new general partner by unanimous vote. The Tax Court held that the partnership lacked the corporate characteristic of continuity of life, inter alia, because "such contingent continuity of life did not resemble that of a corporation." Id.
requirement of unanimous agreement to continue the business of a LLC after dissolution. In Private Letter Ruling 9010027\textsuperscript{124}, the Service held that a Florida LLC possessed continuity of life because its Articles allowed the remaining members to continue the business following a member's death or withdrawal by only a majority vote (as opposed to a unanimous vote). That provision may have violated Florida law which required unanimous consent of the remaining members to continue the LLC, absent a "right to continue."\textsuperscript{125} Nevertheless, the ruling sheds considerable light on the Service's interpretation of the language in Treasury Regulation Section 301.7701-2(b)(2).

The Service has not had the occasion to determine the effect of a "right to continue" provision conclusively.\textsuperscript{126} However, in three letter rulings concerning partnership classification of Florida LLCs, the Service specifically noted the absence of such a provision before concluding the LLC lacked continuity of life.\textsuperscript{127} That notation creates a strong implication that the Service would find continuity of life if a "right to continue" provision were present. Furthermore, given that an LLC with such a provision could continue indefinitely, that interpretation appears correct. Thus, LLCs possessing a "right to continue" must lack two of three remaining corporate characteristics in order to achieve partnership classification. Absent a "right to continue," a LLC will lack continuity of life.

B. Centralization of Management

As mentioned above, members may structure an LLC so that elected managers operate the day-to-day business (mandatory in Colorado). However, because the Treasury views centralized management as a corporate characteristic, members must structure the LLC so that election of managers does not have unintended income tax consequences. For income tax purposes, an organization will possess centralized management "if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed."\textsuperscript{128} Moreover, centralized management does not exist if the centralized authority is subject to ratification by the members of the organization,\textsuperscript{129} and if the

\textsuperscript{124} Priv. Ltr. Rul. 9010027 (December 7, 1989).

\textsuperscript{125} FLA. STAT. § 608.441(1)(c)(Supp. 1990)(emphasis added). The members can only add provisions to the Articles that are "not inconsistent with the law." FLA. STAT. § 608.407(1)(d)(Supp. 1990). Clearly then, where the statute expressly requires unanimous consent, the members cannot substitute majority consent.

\textsuperscript{126} Only Florida and Kansas provide for such a statutory right, see supra section II.D.


\textsuperscript{128} Treas. Reg. § 301.7701-2(c)(1)(as amended in 1983).

\textsuperscript{129} Treas. Reg. § 301.7701-2(c)(3)(as amended in 1983).
powers and functions of the centralized body amounts to little more than ministerial acts.\textsuperscript{130}

In practice, the focus of inquiry has been on the representative character of management, rather than its centralized structure.\textsuperscript{131} The Treasury Regulations reflect that emphasis: "Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization . . . ."\textsuperscript{132} The impetus behind adoption of that language was a barrage of criticism received by the Treasury over proposed regulations which would have effectively found centralized management in every limited partnership.\textsuperscript{133} Responding to that criticism, the Treasury added the following language to section 301.7701-2(c)(4): "[L]imited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act, generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners."\textsuperscript{134}

Under that standard, unless limited partners own "substantially all" the interests in the organization (and thus, the general partners own an insubstantial interest), the Treasury views the activities of the general partners as primarily self-interested, and not representative in character, i.e., the general partners will not resemble directors, acting as representatives of stockholders.\textsuperscript{135} While that language clearly nar-

\begin{enumerate}
\item\textsuperscript{130} Id.
\item\textsuperscript{131} See Zuckman v. United States, 524 F.2d 729, 738 (1975).
\item\textsuperscript{132} Treas. Reg. § 301.7701-2(c)(3)(as amended in 1983).
\item\textsuperscript{133} 24 Fed. Reg. 10450. The proposed regulations essentially took the position that because management of a limited partnership is concentrated in the hands of the general partners, it would always possess centralized management. The criticism of that view was that the Treasury had long recognized a distinction between centralized management in the corporate sense and the limited partnership sense, respectively. In the corporate setting, management is exercised in a representative capacity. In a limited partnership, however, the general partners act primarily out of their own interest, subject only to a fiduciary responsibility to the other partners. Because income tax classification turns on the organization's resemblance to a corporation, the focus must therefore be on the "representative," rather than the "centralized character of management. See Zuckman v. United States, 524 F.2d 729 (1975).
\item\textsuperscript{134} Treas. Reg. § 301.7701-2(c)(4)(as amended in 1983).
\item\textsuperscript{135} Case law has also recognized a related characteristic of centralized management in the context of limited partnerships. In Larson v. Commissioner, 66 T.C. 159 (1976), the Tax Court held that a limited partnership possessed centralized management, not merely because the petitioner had failed to demonstrate that the general partner owned a "meaningful proprietary interest," but also because the limited partner could remove the general partner. While such a power would appear to shift the locus of power away from the general partners to the limited partners, the court viewed the situation of the general partner as "not at all analogous to the independent proprietary interest of the typical general partner." Id. at 178.
rowed the instances in which centralized management may be found, its use of the terms "ordinarily" and "substantially all" offers little solace to the taxplanner.\textsuperscript{136}

By analogy, the election of managers would not conclusively establish the existence of centralized management. Rather, the inquiry would delve deeper into the ownership of the LLC. If the members designate managers who are not also members, i.e., managers who own no interest in the business, the organization will always possess centralized management because it cannot be said that the managers are acting in their own behalf. On the other hand, the opposite conclusion follows if the members opt to manage the business themselves in proportion to their capital contributions, because no person will be making decisions on behalf of the true owners.\textsuperscript{137} Awareness of those two scenarios will be a useful planning tool because they add a known factor to the classification analysis.

Regrettably, the test breaks down somewhat when the Articles vest decision-making powers in managers who own an interest in the LLC.\textsuperscript{138} In those situations, the same analysis used when classifying a limited partnership would presumably apply; that is, the percentage ownership of a managing member would be determinative. Ironically, in a ruling billed as legitimizing partnership classification for LLCs, the Service appeared to impose a stricter centralized management standard on LLCs\textsuperscript{139}

In Revenue Ruling 88-76,\textsuperscript{140} the Service treated a Wyoming LLC as

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\textsuperscript{136} There appears to be much uncertainty over what level of ownership will qualify as "substantially all." The Tax Court has added more vague language to the analysis, finding a lack of centralized management when the general manager owns a "meaningful proprietary interest." Larson v. Comm'r, 66 T.C. 159, 177 (1976). This new language adds little to the analysis in the way of clarification. Perhaps the best insight into how much is "substantially all" can be found in Revenue Procedure 89-12, 1990-1 C.B. 798.

As stated earlier, that pronouncement states that the Service, as part of an advanced ruling, will not hold that a limited partnership lacks centralized management if the limited partners own more than 80 percent. Again, Revenue Procedure 89-12 specifies only conditions for advanced rulings, and is not intended to provide substantive rules for determination of partnership status. Nevertheless, the 80 percent mark is a good measuring stick for investors planning to organize a LLC because it sheds light on the level of ownership the Service considers substantial.

\textsuperscript{137} This option is not available to the members of Colorado LLCs. See supra, section II.B.

\textsuperscript{138} One commentator has suggested that members could ostensibly retain management control but agree among themselves to centralize management decisions. Comment, supra note 50, at 391. However, the Service will probably not accept this form over substance solution given the Service's emphasis on the representative character of management, rather than the formal structure of the LLC. See supra note 132 and accompanying text.


possessing centralized management after finding that the entity was managed by designated managers (who also happened to be members). If the Service reads this ruling literally, any LLC which designates managers will automatically possess centralized management, not withstanding the possibility that the managers could own a "meaningful proprietary interest." The Service could not have intended to create such a double standard, given that it later announced parallel advanced ruling requirements for limited partnerships and other entities seeking partnership classification.

Specifically, Revenue Procedure 89-12 section 4.06 provides that the Service will not rule that a partnership lacks centralized management if the limited partners own more than eighty percent of the total partnership interest. Apparently, the more insignificant the interest of the general partners, the greater the chance that the Service will find centralized management. Because Revenue Procedure 89-12 applies to all entities seeking partnership classification, that standard applies with equal force to LLCs.

Thus, assuming the members desire to manage the business in some measure, it may be wise to plan the LLC so that it will lack two of the remaining three corporate characteristics. The corporate characteristic of limited liability will be considered next.

C. Limited Liability

An organization possesses the corporate characteristic of limited liability "if under local law there is no member who is personally liable for the debts of or claims against the organization." Further-

141. The Tax Court has stated that centralized management will not exist where the general partners own a "meaningful proprietary interest" because they will be acting in their own behalf and not in a representative capacity. Larson v. Comm'r, 66 T.C. 159 (1976).

142. Limited partnerships are classified using the ownership test. See supra notes 134-36 and accompanying text.

143. Rev. Proc. 89-12, 1989-1 C.B. 798. That Revenue Procedure purports to impose the same requirements on all organizations seeking an advanced ruling on partnership classification, whether the business is a limited partnership or "any other organization formed under a law that limits the liability of any member for the organization's debts and other obligations to a determinable fixed amount." Id.

144. Failure to satisfy § 4.06 will only preclude a specific ruling that centralized management is lacking. Rev. Proc. 89-12, 1989-1 C.B. 798. The entity may still obtain partnership classification if it satisfies the remaining criteria of 89-12 and the Treasury Regulations. Id.

145. Id. § 4.06. That arbitrary line is merely a ceiling, and the Service will also consider "all facts and circumstances, including limited partner control of the general partners (whether direct or indirect)." Id. For LLCs, this indicates the Service will consider the managers' rights and duties as provided in the statute, regulations, and operating agreement, in addition to their ownership interests.


147. The Treasury Regulations provide that "[p]ersonal liability means that a creditor
more, a member will have personal liability despite an agreement to
the contrary\textsuperscript{149} if under local law he remains liable to creditors. In the
case of partnerships organized under either the UPA and RULPA,\textsuperscript{150}
general partners are personally liable. Thus, those entities will always
lack limited liability for federal income tax purposes.\textsuperscript{151}

By contrast, neither the members nor the managers are liable for
LLC debts. Thus, it appears that an LLC will always possess the cor-
porate characteristic of limited liability. However, a blemish ap-
ppeared in the Treasury's otherwise crystal clear treatment of limited
liability. In its attempt to create a safe harbor for corporate general
partners of a limited partnership, the Service left open an avenue by
which certain qualifying LLCs could argue against limited liability.
Revenue Procedure 89-12 section 4.07 provides that if a corporate gen-
eral partner maintained a net worth equal to at least 10 percent of the
total contributions of the limited partnership, then, for advance ruling
purposes, the partnership would be treated as lacking limited liabil-
ity.\textsuperscript{152} Section 1.02 of that Revenue Procedure provides that: "References to 'general partners' ... apply also to comparable members of an
organization not designated as a partnership ... [but seeking partner-
ship classification]; the general partners of such an organization will
ordinarily be those with significant management authority relative to
the other members."\textsuperscript{153}

Arguably then, an LLC would similarly lack limited liability if a

\textsuperscript{148} Id.
\textsuperscript{149} Specifically, the regulations state: "[A]n agreement under which another person,
whether or not a member of the organization, assumes such liability or agrees to
indemnify such member for any such liability." \textit{Id.}
\textsuperscript{150} The Treasury Regulations contain an exception for the personal liability of a gen-
eral partner in a limited partnership. Personal liability will not exist if the gen-
eral partner has no substantial assets and is merely a 'dummy' acting as the agent
However, this exception has apparently been rendered meaningless because of its
circular reasoning. See \textit{Zuckman v. United States}, 524 F.2d 729 (Ct. Cl. 1975). In
\textit{Zuckman} the Court of Claims found that the Treasury Regulations mandate that:

[W]here the general partner of a limited partnership has no assets, only
two alternatives may follow: (1) if it is not a "dummy," then it is person-
ally liable; or (2) if it is a "dummy," then the limited partners for whom
it acts as agent and who in turn serve as its principal, are personally
liable. In either case, the limited partnership cannot have limited liabil-
ity, inasmuch as at least one of its "members"-whether general or lim-
ited-must at all times bear personal liability.

\textit{Id.} at 741 (emphasis in original).
\textsuperscript{151} \textit{Treas. Reg. § 301.7701-2(d)(1)(as amended in 1983).}
\textsuperscript{152} \textit{Rev. Proc. 89-12, 1989-1 C.B. 738.}
\textsuperscript{153} \textit{Rev. Proc. 89-12 § 1.02, 1989-1 C.B. 798.
corporate manager sustained the requisite net worth. However, the Service has corrected this flaw by rendering section 4.07 inapplicable to LLCs. Thus, it appears quite clear that an LLC will always possess limited liability for purposes of federal income tax classification.

D. Free Transferability of Interests

The shares of stock of a corporation are, in theory, freely transferable by the owner without reference to the wishes of other members. Free transferability exists in an organization, for federal income tax purposes, when “each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization.” However, substitution refers to a complete transfer of all the attributes of the member's interest in the organization, not merely a right to share in the profits.

Unlike the regulations dealing with the other three corporate characteristics discussed, Treasury Regulation section 301.7701-2(e) makes no reference to either the presence or lack of free transferability of interests in organizations formed under the UPA or RULPA. However, it is clear that interests in a partnership formed under the UPA are not freely transferable because “[n]o person can become a member of a partnership without the consent of all the partners.” It is less clear in the case of entities organized under the RULPA.

Under the provisions of the RULPA, partnership interests are assignable in whole or in part. However, the act grants partners the ability to place restrictions on transferability in the partnership agreement. Thus, whether interests in limited partnerships are freely transferable depends on the agreement of the partners. For LLCs, unless all members approve a proposed transfer, the transferee is entitled only to share in the profits, and can exercise no voice in management. Thus, an LLC always lacks free transferability.

In summary, an LLC will always possess limited liability, and always lack free transferability of interests. Hence, the federal income tax classification of an LLC depends on whether it lacks either con-

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157. Id.
158. Id.
159. UNIF. PARTNERSHIP ACT § 18(g)(1914).
161. Id. at § 704(a)(i).
162. See supra section II.C.
tinuity of life or centralized management. As discussed above, a LLC may have centralized management unless its members chose to manage the business themselves. Further, a "right to continue" stated in the Articles, will cause the LLC to possess continuity of life. Thus, an LLC need only avoid those two obstacles to obtain partnership classification.

IV. UNCERTAINTY SURROUNDING ACCEPTANCE OF THE LLC’S LIMITED LIABILITY IN FOREIGN JURISDICTIONS

While the LLC’s ability to achieve partnership status for federal income tax purposes is now a settled matter, there remains uncertainty over the limited liability it purports to offer its members. Specifically, commentators have expressed concern over whether foreign jurisdictions (principally other states) will respect the LLC’s limited liability. To be sure, a number of cases suggest treatment of all unincorporated associations as general partnerships, despite the limited liability those entities possess in their state of organization. However, developments in the laws of corporations and limited partnerships since those cases were decided arguably renders that approach obsolete as to LLCs. The following discussion begins with a general presumption in favor of deference to the laws of the state of organization.

The general principle of comity requires that one state recognize and admit operation within its jurisdiction, of the laws of another, when not contrary to its own public policy. Specifically, the forum state generally presumes that an entity, if not forbidden by its charter, may exercise its powers within the forum state. That presumption is rebuttable only by direct enactments or by the public policy of the forum, as deduced from the general course of legislation or the settled adjudications of its highest courts. In order to focus on policy considerations, it will be assumed that no law exists which expressly forbids recognition of the limited liability of members of foreign entities, or which requires the express permission of the state as a precondition to the entity’s recognition.

164. See Hamill, supra note 54, at 746; Comment, supra note 50, at 402.
166. See Annotation, Personal Liability of Stockholder, Officer or Agent for Debt of Foreign Corporation Doing Business in the State, 27 A.L.R. 4th 387; Restatement (Second) of Conflict of Laws § 6 (1969).
168. Id. at 356. See generally Restatement (Second) of Conflict of Laws §§ 6, 295, 297 (1969)(concerning liability of limited partners and shareholders when business is conducted in foreign jurisdictions).
A. Policy of Creditor Protection

Because this country has seen little variation from state to state in the types of business entities permitted by statute, case law illuminating the policy issues involved is scant. Commentators have used the Texas case of Means v. Limpia Royalties\(^{169}\) to demonstrate one state's refusal, on policy grounds, to recognize an organization's limited liability.\(^{170}\) In Means, the Court of Civil Appeals of Texas allowed a purchaser to rescind a contribution of Texas land to an Oklahoma business trust, holding that, contrary to the representations of the promoter and the law of Oklahoma the shareholders would be liable for trust obligations created in Texas. However, beyond its holding the court offered no explanation for Texas' policy, and asserted only that its opinion was consistent with a long line of decisions.\(^{171}\)

One of those earlier Texas cases provides some clarification. In Wells v. Mackay Telegraph-Cable Co.,\(^{172}\) the Court of Civil Appeals of Texas held that shareholders of a Texas common law business trust were liable as partners for trust debts despite a provision against personal liability in the declaration of trust. According to the court, persons associated for the purpose of carrying on a business enterprise are jointly and severally responsible unless the business is organized as a limited partnership or corporation, or unless they specially contract for limited liability. The court explained that:

> The public in its dealings with such business organizations has a right to the protection afforded them by our statutes regulating the formation of corporations. This protection would be greatly lessened if it should be held that by declaring and recording a declaration of trust persons can associate themselves together for business purposes, giving their organization all the powers of a corporation and limiting their individual liability, without complying with statutes which require proof of the funds or assets of such an association before a charter will be granted it to conduct its business.\(^{173}\)

Presumably, the court was speaking only of creditors when it used the term "public." It would hardly be tenable to suggest that, by refusing to recognize shareholder immunity from personal liability, the court was protecting shareholder assets. Thus, this policy, at least insofar as it has been articulated in Texas, assumes that corporation laws protect creditors. However, even if protecting creditors is a legitimate policy, forcing investors to incorporate no longer furthers that goal, assuming it ever did.

States now sanction corporations organized under laws that offer little protection for creditors, and routinely recognize foreign corporations structured under similar laws. Perhaps the most notable change

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170. See, e.g., August and Shaw, supra note 23, at 205; Comment, supra note 50, at 402.
173. Id. at 1007. See also Hibbs v. Brown, 190 N.Y. 167, 82 N.E. 1108 (1907).
affecting creditor protection is the departure from the concept of par value, and its related disclosures in the articles of incorporation.\textsuperscript{174} The concept of par value was originally designed, in part, to assure creditors that a firm had incorporated with a minimum level of capital.\textsuperscript{175} But it actually increased creditor risk after corporations began issuing watered stock.\textsuperscript{176} Moreover, in those states retaining par value corporations have emasculated any disclosure value by issuing nominal par shares (e.g. one cent, ten cents, or one dollar).\textsuperscript{177} Consequently, the only real protection offered to creditors by present corporation laws is a limitation on distributions to shareholders.\textsuperscript{178} States will find it difficult to use the policy of creditor protection to deny members limited liability because LLCs impose similar distributional limitations.

Corporation laws generally leave creditors to fend for themselves because, in most circumstances, creditors are in a position to do so. A voluntary creditor, because of an existing contractual relationship, can simply require compensation for any assumed risk as a term of the contract.\textsuperscript{179} Thus, in the usual situation the choice between limited liability or unlimited liability has less to do with equity, and more to do with economic efficiency.\textsuperscript{180} While these economic efficiencies may be less pronounced in closely held corporations (and presumably any closely held entity),\textsuperscript{181} the pervasiveness of the close corporation is compelling evidence that, at least for some small entities, limited liability is an efficient rule. Accordingly, at least insofar as protection of

\textsuperscript{174} About 15 states have followed the RMBCA's lead and entirely abandoned the concept of par value. See R. \textsc{Hamilton}, supra note 155, at 308. In most of the remaining states, the articles of incorporation must state either the par value of the shares of each class or that the shares are issued "with no par value" or "without par value." \textit{Id.} See, e.g., \textsc{Me. Rev. Stat. Ann.} tit. 13-A, \S 403(2)(A)(2) (1981) (shareholders may opt out of par value). \textit{Cf. Neb. Rev. Stat.} \S 21-2052(4) (Reissue 1987) (par value state).

\textsuperscript{175} R. \textsc{Hamilton}, supra note 155, at 308.

\textsuperscript{176} \textit{Id.} at 309.

\textsuperscript{177} In addition to rendering the disclosure requirement useless, corporations that issue nominal par shares achieve greater flexibility in making distributions to shareholders because more capital will be classified as surplus, and thus available for distribution. \textit{Id.} at 315. Hence, creditors cannot rely solely on capital as a means of payment. Instead, most creditors require some form of collateral on certain business assets to secure their claims.

\textsuperscript{178} See, e.g., \textsc{Revised Model Business Corp. Act} \S 6.40 (1985). \textit{But see supra} notes 176-77 and accompanying text (discussing impairment of protection offered by limitations on distributions caused by use of nominal par shares).


\textsuperscript{180} \textit{See Easterbrook} \& Fischel, supra note 179, at 93.

\textsuperscript{181} \textit{Id.} at 109-10.
voluntary creditors is concerned, there appears to be no policy reason to deny businessmen an alternative to corporations beyond limited partnerships.

The basis for that conclusion, as stated above, is that limited liability is merely a default rule capable of being contracted around, and as such finds its justification in economic efficiency. Of course, such a judgment presumes that the creditor has sufficient information to evaluate the added risk, and require advance compensation. But what about where creditors either have bad information because of a member's misrepresentation, or are unable to bargain for advance compensation because they are involuntary creditors? For the reasons discussed below, the judiciaries of foreign jurisdictions should only impose personal liability in the limited circumstances where the corporate veil is pierced.

The threat of misrepresentation is equally prevalent where corporations are involved. For example, a subsidiary corporation could use a name deceptively similar to its parent company, leading unsophisticated creditors into reasonably believing they were dealing with the parent company. Another possible scenario is where the creditor is misled into believing the risk of default is lower than it actually is, causing the creditor to demand less compensation. Or, a more analogous scenario for LLCs is where a major shareholder orally represents that she will make good on a corporate debt, but shields herself from liability with the statute of frauds and parole evidence rule. These types of conduct result in creditors assuming an excessive amount of risk.

Limited liability imposes a similar hazard on involuntary creditors (usually tort claimants), but for an entirely different reason. Tort claimants assume added risk because they cannot bargain for advance compensation. However, despite the potential for uncompensated risk, courts have responded not by stating a public policy against corporate limited liability, but rather by piercing the corporate veil in particular cases involving misrepresentation and involuntary creditors. Thus, for LLCs, the question is whether they pose a sufficiently greater threat to creditors than do corporations such that states should treat LLCs differently.

The answer to that question is of course empirical. However, based

183. Easterbrook & Fischel, supra note 179, at 112.
185. Easterbrook & Fischel, supra note 179, at 112; Halpern, Trebilcock & Turnbull, supra note 179, at 145-47.
186. Easterbrook & Fischel recommend several alternative methods for decreasing the incentive created by limited liability to engage in overly risky activities. See Easterbrook & Fischel, supra note 179, at 114-16.
on experience in corporation law, commentators have suggested that small entities with less capital to lose are more likely to engage in risky conduct. Despite this added risk states do not deny shareholders of close corporations limited liability as a matter of course, or even raise a presumption against it. Rather, courts examine the adequacy of capitalization as a factor in deciding whether to pierce the corporate veil on a case-by-case basis. Given that LLCs probably have no greater incentive to undercapitalize than do close corporations, there appears to be no policy reason to treat LLCs differently. Creditor protection under the ULPA and RULPA is discussed in the following section.

B. Policy Against Statutes in Derogation of the Common Law

Prior to enactment of the ULPA, courts often refused to recognize the immunity of limited partners of defectively formed limited partnerships on the ground that under such circumstances limited liability derogated from the common law. In response, the drafters of the ULPA adopted provisions, and a general policy, designed to grant limited partners the same sense of security from personal liability as shareholders of corporations. More recently, the RULPA bolstered that position with even stronger protection for limited partners. Arguably, the policies embodied in those acts (as adopted in every state) apply equally well to LLCs, and therefore foreclose treatment of members as general partners.

The chief provision of the ULPA gives a person who erroneously believes that she has become a limited partner of a limited partnership an opportunity to withdraw her interest under certain circumstances, and not be held liable as a general partner. However, that provision flatly defies a line of common law authority requiring any person sharing in an enterprise’s profits to likewise be liable for its losses. Hence, to be clear about their objectives the drafters added the rule of construction that: "The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this article."

The ULPA’s disagreement with the common law authority appears fundamental and straightforward:

The act proceeds on the assumption that no public policy requires a person

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187. Lewis, supra note 1, 723.
188. UNIF. LTD. PARTNERSHIP ACT § 7 (1916).
189. The parent cases creating that doctrine were Grace v. Smith, 2 Wm. Blackstone 998 (1775) and Waugh v. Carver, 2 H. Blackstone 235 (1793). The other line of authority holds that, while the right to participate in profits affords cogent evidence that a partnership exists, the real test is whether an agency relationship is present. Cox v. Hickman, 8 House of Lords Cases 288 (1880). It is needless to explore the ancient circumstances for the two lines. Rather, our focus is properly on how current developments render that analysis moot.
190. UNIF. LTD. PARTNERSHIP ACT § 28 (1916).
who contributes to the capital of a business, acquires an interest in the profits, and some degree of control over the conduct of the business, to become bound for the obligation of the business, provided creditors have no reason to believe at the times their credits were extended that such person was so bound. 191

That statement refers to any "person", not simply to limited partners. Accordingly, based only on that policy statement, states adopting the ULPA should find it equally acceptable for members of LLCs to retain their limited liability when the LLC transact within the state's boundaries, so long as the LLCs do not mislead creditors into believing members will be personally liable. However, to some extent that policy assumption is inconsistent with the actual ULPA provision governing liability of limited partners which imposes liability if the limited partner partakes in control of the business, regardless of any reliance. 192

In practice, courts have found it difficult to determine when limited partners cross the "control" line. 193 Perhaps some of the courts' trouble stems from the inequity of granting a windfall to creditors who simply assume they are dealing with a particular type without performing a reasonable investigation. Gilman Paint & Varnish Co. v. Legum 194 reflects that concern. In Legum, a trade creditor who was unaware that he was dealing with a limited partnership attempted to hold a limited partner personally liable. The Court of Appeals of Maryland rejected the creditor's assertion, however, on the ground that the limited partner had made no misrepresentation of his status to the creditor. Indeed, Legum involved a partner who, unlike a managing member of a LLC, had not exercised management control. However, the court did not depend on that fact in reaching its decision.

The court underscored that "[the creditor] cannot assume that his prospective purchaser is necessarily a corporation or a partnership of the state where the order is to be sent." 195 Rather, according to the court, a creditor must inquire as to the type of business to which it is extending credit. 196 Arguably, the court would have come to the same conclusion if the defendant had been a member of a LLC despite managing the business, because a reasonable investigation of the law would disclose member limited liability. This represents sound policy, both on grounds of equity and in light of the assumption embodied in the ULPA. 197 The RULPA also appears to have endorsed this policy.

The RULPA shields limited partners from personal liability de-

191. Commissioner's note to the UNIF. LTD. PARTNERSHIP ACT § 6 (1916).
192. 197 Md. 665, 80 A.2d 906 (1951); see UNIF. LTD. PARTNERSHIP ACT § 7 (1916).
195. Id. at 668, 80 A.2d at 907.
196. Id. at 668, 80 A.2d at 907-08.
197. See supra note 193 and accompanying text.
spite participation in the control of the business, so long as the limited partner's conduct does not cause the creditor to reasonably believe that the limited partner was actually a general partner. Thus, it appears that in the thirty four states which have adopted the RULPA, limited liability and assumption of management duties are not inherently incompatible. Arguably then, absent any misrepresentation the judiciary in those states should not object to LLCs combining the same concepts, given the LLC's resemblance to a partnership. For LLCs operating in the remaining states which follow the ULPA, member status is much less certain because of the gap between the language of the act's policy assumption and its actual liability provision. While the duty to inquire recognized by the *Legum* court should bridge that gap, there is no assurance that other jurisdictions, or even the high court of Maryland, will agree.

V. CONCLUDING REMARKS

LLCs offer businessmen an alternative to corporations and partnerships for conducting their business affairs by combining the advantages of partnership taxation and limited liability. Following a period of years when the income tax status of the LLC was considerably in doubt, its ability to achieve partnership status now appears to be a settled matter. Moreover, while some question persists about the LLC's capacity to retain its limited liability while transacting in foreign jurisdictions, state acceptance of corporation laws that offer little protection to creditors, and state adoption of either the ULPA and RULPA with their corresponding policy of reliance, should give members a compelling argument in favor of limited liability.

_Sylvester J. Orsi '92_

199. See supra section II.