

# **I. WHY LIMITED LIABILITY COMPANIES?**

## **A. History and Types of LLC's:**

The concept of the limited liability company did not begin to develop until the 1970's. In 1977 the state of Wyoming enacted the first limited liability company act in an effort to attract franchise revenue to the state. Five years later, in 1982, Florida followed with its own act which was patterned upon the Wyoming act. Questions were immediately raised as to whether this entity would be treated for federal income taxes purposes as a partnership and thus have the desired pass-through status or whether it would be treated as an association taxed as a corporation. In 1988, eleven years after Wyoming adopted its limited liability company act, the IRS published Revenue Ruling 88-76 which classified a Wyoming LLC which met certain factual criteria as a partnership for federal income tax purposes. In response to 88-76, the other states which had not already adopted LLC acts began adopting their own limited liability company acts. In 1991 Delaware adopted its first Limited Liability Company Act. The Delaware Act underwent major revisions in 1995 and 1997, thereafter it has been amended in small proportions almost every year in an effort to keep Delaware's Act as the leading and most cutting edge Act in the nation.

A limited liability company is a non-corporate business form which provides its members with limited liability and also allows the members to participate actively in the entity's management without becoming personally liable for the entity's obligations. At its most basic level, a limited liability company may be viewed as a partnership whose partners have limited liability. The limited liability company has all of the best features of partnerships and corporations with none of the corporate rigidity and with the limited liability which the partnership form lacks. As with a partnership, the relationship between the members, and the members with the company, is determined by contract. That contract is called a company agreement or operating agreement. The company agreement may be either written or oral. In the absence of any agreement or where the agreement is otherwise silent, the Delaware Act becomes the default company agreement.

The company may be managed by all or just some of its members or by one or more non-members. If it is managed by less than all of its members, the person(s) who manage the business is then called the manager. Some drafters of company agreements refer to a manager who is also a member as the managing member. There is no legal significance in the differing titles. A company may have one or more managers. The manager need not be a member. We speak about either member-managed companies or manager-managed companies. Managers are similar to officers and directors in the corporate sense. A manager may have a title such as president, however, such titles are optional. The manager may also delegate management to a non-manager. The non-manager may also have a title such as president.

The first Delaware Limited Liability Company Act in 1991 has been substantially amended. The Delaware Act in its current form provides substance and guidance to the practitioner, and provides that the relationship between the members of the limited liability company will be governed by the principles of contract. Section 18-1104 provides that “In any case not provided for in this chapter, the rules of law and equity, including the law merchant, shall govern.” The Delaware Act built upon its predecessors and continues to evolve. The Delaware Act gives limited liability companies the same flexibility as a general partnership, however, each member of the limited liability company has the same, identical, limited liability as a stockholder of a Delaware corporation under the GCL. Income, expense and any loss of the limited liability company are recognized for income tax purposes by its members, and no income taxes are paid by the LLC unless it elects to be treated as a corporation. There is no requirement that an LLC publish a legal notice of its formation, nor are there any minimum capital requirements, nor any requirements that it file annual financial reports, and there is no requirement that it publicly file the names of its members or managers.

The genesis of the limited liability company was in tax law. Investors in real property had traditionally held such assets in their individual name or in pass-through entities such as a general partnership or a limited partnership. Investors seek to limit their liability to third parties, however, if they used a corporation as the vehicle to provide limited liability, the loss generated from passive sources, such as depreciation and other losses, was trapped at the corporate level in a C corporation and the investor could not enjoy the shelter from their investment on their

personal return. S corporations were at one time popular, however following the imposition of the passive activity regulation under tax laws, the S corporation became less attractive.

The Delaware Act is considered to be the most modern and most flexible in the nation. Delaware places almost no limitation on the ingenuity of attorneys and business persons in drafting company agreements to meet the needs of business transactions. Unlike corporations, where the business transaction must be structured to meet the requirements of the GCL, the company agreement is structured to meet the needs of the business transaction.

Delaware has adopted only one statutory form of limited liability company, however, as will be explored in depth later in this article, limited liability company's may be either managed by its members or by a manager. Under Section 18-215, a limited liability company agreement may establish or provide for the establishment of one or more series of members, managers or limited liability company interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits or losses associates with specified property or obligations, and any such series may have a separate business purpose or investment objection. These limited liability companies are referred to as "series limited liability companies." Series limited liability companies will be discussed in depth later.

## **B. State Law Governing Limited Liability Companies:**

The Delaware law governing limited liability companies is codified under Title 6 of the Delaware Code, Section 1801, et seq. Under Section 18-1102, the official name of the law is the "Delaware Limited Liability Company Act." Delaware has only the single law governing limited liability companies.

## **C. Comparison to Other Entities:**

In accordance with §18-201(b), a limited liability company is formed at the time of the filing of the initial Certificate of Formation with the Delaware Secretary of State, or at such later

date and time as may be specified in the Certificate of Formation. Section 18-201(a) specifies those matters which must be set forth in the Certificate of Formation. Under Subsection (b), the company is formed if there has been substantial compliance with the requirements of §18-201. The Subsection goes on to provide:

A limited liability company formed under this chapter shall be a separate legal entity, the existence of which as a separate legal entity shall continue until the cancellation of the limited liability company's certificate of formation.

The existence of the company is terminated either by an order of the Delaware Court of Chancery or the filing of a Certificate of Cancellation under §18-203. The Court of Chancery, under §18-802 has the right, on application by or for a member or manager of the company, to enter a decree of dissolution of a limited liability company “whenever it is not reasonably practical to carry on the business in conformity with a limited liability company agreement.

## **1. Limited Liability Partnerships:**

Limited liability partnerships are a species of the general partnership. Prior to the 2005 amendments to the Delaware Uniform Partnership Act (“RUPA”), the partners first had to enter into a general partnership and file a Statement of Partnership Existence with the Delaware Secretary of State. Thereafter, the partnership could elect, pursuant to Section 15-001, to become a limited liability partnership. As a result of the 2005 amendments, a partnership now may be formed as a limited liability partnership, bypassing the need to first establish the general partnership.

Section 15-306(c) provides:

Any obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort or otherwise, is solely the obligation of the partnership. A partner is

not personally liable, directly or indirectly, by way of indemnification, contribution, assessment or otherwise, for such an obligation solely by reason of being or so acting as a partner.

Therefore, while under general partnership law, Section 15-306(a) provides:

Except as otherwise provided in Subsections (b) and (c), all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.

A partner acting within his or her authority on behalf of the limited liability partnership is personally liable for their own actions. They are thus, by virtue of the limitations contained in Section 15-306(c), not liable for the debts or obligations of the partnership or the tortious acts of their fellow partners. In the context of a professional practice, the limited liability partnership shields the partners from the liabilities created by the actions or inactions of their fellow partners.

The limited liability partnership is generally developed in connection with professional practices. The limited liability partnership became effective on August 1, 1993 at the behest of accountants. While Delaware had by that time adopted its first Limited Liability Company Act, the tax laws with respect to limited liability companies were in flux, and it was unlikely that a large accounting practice with hundreds of partners could have qualified under the tax laws to be treated as a partnership rather than an association taxed as a corporation. Therefore, the accountants sought to create the limited liability partnership under the Partnership Act.

The RUPA has, however, several non-waivable provisions which make the limited liability partnership less desirable than the limited liability company for practices other than professional practices. Until recently, Delaware attorneys could not practice as a limited liability company and were limited to practicing within the limited liability partnership. Within recent years, that too has changed.

## **2. General and Limited Partnerships:**

Under the General Partnership Act, a partnership not electing to be a limited liability partnership suffers from the problem that all of the partners are personally liable for the debts and obligations of the partnership. While the creditors must first look to the assets of the partnership to satisfy the debt, once the assets of the partnership are exhausted, then the creditor is free to collect its judgment against the individual partners. Before the advent of limited liability companies, the general and limited partnerships were the only entities available to parties who wished to have the benefits, under the tax laws, of the entity being classified for tax purposes as a partnership (we will deal with Subchapter S elections later in this article).

Historically, the limited partnership suffered from one of the same problems as the general partnership, the general partner of the limited partnership must be generally liable for the debts of the partnership, while the limited partners have the same limitation from liability as the stockholders of a Delaware corporation. Recently, Delaware has engrafted upon the Delaware Revised Limited Partnership Act, Section 17-214. Section 17-214(c) provides:

If a limited partnership is a limited liability limited partnership, (i) its partners who are liable for the debts, liabilities and other obligations of the limited partnership shall have the limitation on liability afforded to partners of a limited liability partnership under the Delaware Revised Uniform Partnership Act. . .

A limited partnership which has elected to be a limited liability limited partnership is required under Section 17-214(a)(2) to have the last words or letters of its name the words “limited liability limited partnership,” or the abbreviation “L.L.L.P.,” or the designation “LLLP.”

## **3. C Corporations:**

Corporations designated as “C corporations” or “S corporations” are classifications which exist solely under the Internal Revenue Code and not the Delaware General Corporation Law (“DGCL”). Under the DGCL, there are general corporations and close corporations. Generally speaking, under the Internal Revenue Code, a C corporation is an entity separate from its owners and is a taxpayer. The income and expense of the corporation is reported on the corporation’s income tax return, and unless there has been a distribution by way of dividend to the stockholders, the profits of the corporation are not separately taxable to the stockholder.

Historically, the general corporation has been business entity most often selected by parties entering into business and business transactions. Under the DGCL, the stockholders of a Delaware corporation are not liable for the debts or other obligations of the corporation unless they have agreed in writing to be liable for those debts. This concept is known as limited liability. The stockholders, when investing in the corporation, purchase the stock for cash or other consideration. The consideration which is agreed to be paid to the corporation for the stock represents the liability of the stockholder. The stockholder’s investment in the company is always at risk and, unless the stockholder has in fact not paid for the stock, the stock being considered partially paid, the stockholder is not required to make up any of the debts of the corporation. If the stock is partially paid, the stockholder remains liable for the unpaid portion of the subscription price. With the exception of an unpaid subscription, generally the only time that the stockholder is liable for a debt of the corporation under the DGCL are those cases generally referred to as “piercing the corporate veil,” that is, cases where the stockholder has used the corporation to commit fraud or has used the corporation in a generally inequitable manner to injure another party.

The DGCL provides strict ground rules for the operation of the corporation and the relationship between the stockholders and the corporation. The management of the business of the corporation is in the hands of the corporation’s board of directors. The directors are elected by the stockholders. Vacancies within the board of directors are filled by the remaining directors, and in the absence of any continuing directors, by the stockholders. The day-to-day operations of the corporation are managed by the officers, who are elected by the directors. This

relationship of the stockholders electing directors and directors electing the officers is set out in the DGCL. The relationship between the stockholders and the directors and the directors and the officers are somewhat rigid and do not allow for a free interplay needed in private transactions. The provisions of the DGCL require the drafter to fit the transaction within the strictures of the DGCL, while under the Limited Liability Company Act, and to a lesser extent, the Revised Uniform Partnership Act, those laws allow for much more flexibility in the drafting of the structure of the entity.

#### **4. S Corporations:**

S corporations are a function of the Internal Revenue Code. Under the Internal Revenue Code there are limits on the number of stockholders in a Subchapter S corporation. Additionally, there are limitations on who may become a stockholder in an electing Subchapter S corporation. A person who is not a citizen of the United States is prohibited from being a stockholder in an electing Subchapter S corporation. The rules dealing with the pass-through of income and loss limit the amount of loss which a stockholder may take on their personal tax return.

Under the DGCL, the by-laws of the corporation or a stockholder agreement may provide for limitations on the number of stockholders and the qualifications of persons who are stockholders so as to avoid the possibility of an inadvertent loss of qualification as an electing Subchapter S corporation.

Generally, the tax rules dealing with Subchapter S corporations limit the losses which the stockholder may recognize on their personal returns to the stockholder's basis in their stock. The result of these limitations has been that Subchapter S is not an appropriate vehicle for the ownership of real property where the owner anticipates that the losses created by depreciation and other non-cash expenses will be greater than income. Currently, given the tax treatment given to limited liability companies, there are few reasons to use Subchapter S.

#### **5. Other Entities:**

There remains one additional primary form of business entity under Delaware law, the statutory trust. The statutory trust was previously called the Delaware business trust. Both the trustee and the beneficiaries of the statutory trust have the same limited liability afforded to stockholders under the DGCL. Under the other forms of business entity in Delaware, there is no good reason for a non-resident to have a place of business in Delaware unless they are in fact transacting business in this state, as having an office in Delaware will make the company susceptible to Delaware income taxes. The statutory trust, on the other hand, must have a Delaware presence by having at least one trustee which has an office in the State of Delaware. Statutory trusts are generally used to hold assets rather than actually transacting an active business. The trustee holds the assets, collects the income and loss, and distributes the income and loss to the beneficiaries in accordance with the trust document. The statutory limitation of liability has made the Delaware statutory trust an effective entity for holding assets such as cruise ships, oil tankers jumbo jets, as well as income-producing properties such as shopping centers and office buildings. In each case, the asset is generally leased by the trustee to a third party who operates the asset and remits rental payments to the trustee. In most cases, the trustee is not involved in the day-to-day operation of the asset, and the asset is generally net leased to the operator.

C and S status of a corporation represent, in the case of an S corporation, a tax election filed with the IRS, and in the case of a C corporation, the absence of any such tax election. The corporation itself is formed under Delaware law in the same manner whether or not the S election is to be made. In some cases the drafter of the Certificate of incorporation of the S corporation will include in the Certificate provisions to protect the corporation against inadvertent loss of the status such as there being too many shareholders, entering into a transaction which might jeopardize the election or having a shareholder who or which may jeopardize the election.

The following table compares S Corporations, LLC's, C Corporations and Limited Partnerships:

	<b>Subchapter S Corporation</b>	<b>Limited Liability Company</b>	<b>C Corporations</b>	<b>Limited Partnership</b>
Number of Shareholders/Members	100	Unlimited	Unlimited	Unlimited
Limited Liability	Yes	Yes	Yes	Yes, for Limited Partners, but the General Partner has unlimited liability
Prohibition on Non-Resident Alien Ownership	Yes	No	No	No
Classes of Ownership	One class of stock	No limitations, classes and series of membership or managers are permissible	No Limitations	No limitations
Flexibility of financial structure	Limited by the General Corporation Law	Unlimited	Unlimited	Unlimited
Flexibility in operation	Limited to by-laws, otherwise governed by General Corporation Law	Controlled by contract	Limited to by-laws, otherwise governed by General Corporation Law	Controlled by contract
Flexibility of tax allocations	Must pass the substantial economic effect under Section 704(d)	Must pass the substantial economic effect under Section 704(d)	Must pass the substantial economic effect under Section 704(d)	Must pass the substantial economic effect under Section 704(d)
Basis adjustment if shareholder/member guarantees debt	No basis increase unless the guarantor actually makes payment	No basis increase unless the guarantor actually makes payment	No basis increase unless the guarantor actually makes payment	No basis increase unless the guarantor actually makes payment
Liability for company's debts or other liabilities	Generally none	Generally none	Generally none	Generally none
Creditor protection for interest in the hands of the owner of the interest	None, stock may be seized by stockholder's creditor. Shareholder	Member's creditors may obtain charging order but may not sell or	None, stock may be seized by stockholder's creditor.	Partner's creditors may obtain charging order but may not sell or obtain title to

	generally is not personally liable for corporate debt	obtain title to interests. Member is generally not personally liable for company debts	Shareholder generally is not personally liable for corporate debt	interests. Member is generally not personally liable for company debts
Public disclosure	Officers' and directors' names must be filed annually	None	Officers' and directors' names must be filed annually	General partners' names
Double taxation	Subject to limitations	No	Subject to limitations	No
Management meeting required	Yes, Board of Directors and Shareholders	No	Yes, Board of Directors and Shareholders	No
Capital overseen by public agency	No	No	No	No
Publication of intent to form company	No	No	No	No
Tax of gains on contribution to entity	No gain recognized	No gain recognized	No gain recognized	No gain recognized
Member of an Affiliated Group	No	Yes	Yes	Yes
Special Allocations	Not Permitted, allocations must be pro rata in accordance with share interest	Permitted. Reg. 7.704-1(b)(1)	No	Permitted
Debt as an Adjustment to Basis	No	Yes	No	Yes
Loss Limitation	Limited by basis in stock and any debt owed by company to shareholder	Company debt can increase basis	Limited by basis in stock and any debt owed by company to shareholder	Company debt can increase basis
IRS 754 Election	Not Available	Available	Not Available	Available

Taxability of Distributions of Property	Taxable, loss recognition limited to liquidating distributions	Generally not taxable	Taxable, loss recognition limited to liquidating distributions	Generally not taxable
Participation by Owners Creating Unlimited Liability	Only officers and directors may participate in management, however serving as an officer, director, employee, agent or consultant to a corporation does not create personal liability for corporate obligations	Participation in management does not create personal liability, may make person a manager	Only officers and directors may participate in management, however serving as an officer, director, employee, agent or consultant to a corporation does not create personal liability for corporate obligations	Limited Partners are generally not permitted to participate in management, there are limited safe harbors for certain actions

## D. Who Should Use LLC's?

The better question stated should be “Who should not use LLC's?” The Delaware limited liability company is the most flexible of all of the Delaware business entities, while still providing absolute limited liability to its members (except for those situations where there are bad acts by the limited liability company which would permit a court to assign liability to its members by “piercing the veil.”

In some types of business transactions, it has become standard to use certain types of business entities. In the case of some financing transactions such as commercial jet liners, engineers for commercial jet liners and cruise ships, the industry has selected the Delaware statutory trust as the appropriate form. In the area of public companies, the corporation works best. Other than certain limited areas, the Delaware limited liability company, whether it is managed by its members or by a manager, is generally the first choice. In some situations, the tax laws may militate against the limited liability company. The members of the limited liability

company are subject to self-employment tax, and a limited liability company cannot provide its members with some tax-free benefits, such as medical reimbursement plans.