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Today

Our mini-theme:
Partnerships and LLCs

LLCs: Is the future here?

A HISTORY AND PROGNOSIS

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The landscape of business forms has changed in the last 20 years. The irresistible force of state legislatures and lawyers met and ultimately conquered the immovable object of federal tax restrictions on choice of form. This article sketches how far we have come, and why.

Two business forms dominated at the dawn of the modern era. General partnership was always the form provided for businesses that didn't choose an alternative. Though the general partnership can be used by anyone from mom-and-pop grocery store to international accounting firm, it is best suited to very closely held firms that do little advance planning. All of the owners equally share control, profits, losses and partnership property. To address the disputes that can arise in close-knit relationships, every partner has the right to dissolve the firm and force the sale of its assets. This easy dissolvability puts firms at the mercy of their most fickle or opportunistic members. Even worse, general partners can be held personally liable for business debts.

Enter the corporation. Shareholders are not liable for corporate debts beyond their investments in the firm and lack the power unilaterally to dissolve the firm. But these important advantages come at the price of an owner-level tax on the firm's distributions on top of the levy on the corporation's earnings. Also, just as the partnership form can be a problem for larger firms, so the corporate form can be a problem for smaller ones. Courts enforced alterations in the basic form and legislatures came to offer special models that permitted partnership-type direct management, voting rules and financial sharing.

Despite these changes, the corporate form never forgot its origins as the vehicle for large businesses. Owners of closely held corporations therefore had to be careful to think of everything lest corporate default rules grab them unexpectedly. Most important, owners might find themselves unhappily stuck in the company with no buyers for their shares and no other possibility of exit unless they could persuade their fellow shareholders to dissolve. Courts and legislatures devised remedies to deal with frozen-in owners, but the remedies either failed to match the flexibility of the partnership form or risked having a court impose relief contrary to the parties' agreement.

What we needed was a business form that combined the most useful elements of both partnerships and corporations for closely held firms — limited liability, partnership default rules and flexibility, and flow-through taxation. In other words, we needed the "partneration." From the 1950s through 1970s, as personal income taxes and the risk of tort liability rose, business lawyers pursued this elusive goal just as early explorers searched for the source of the Nile and the Northwest Passage.

In the early 1950s, Congress created the Subchapter S corporation, which permitted partnership-type taxation in the corporate form. Congress hoped this device would satisfy the craving for single-level taxation in the simplest corporations without inviting abuse. But this enforced simplicity makes Subchapter S a kind of straightjacket, limiting the number and type of members and, most important, confining firms to a single-class capital structure.

States also refined the limited partnership form, which permitted limited liability for passive investors. Though general partners in such firms were liable for partnership debts, they could incorporate, thereby creating what has been called a "corpnership." At the same time, limited partnerships had the advantage of partnership-type taxation.

However, tax classification rules determined the contractual terms that would make a firm a corporation for tax purposes — including excessive continuity, transferability and centralization of management. Limited partnerships also had to deal with the state-imposed "control rule," which treated the limited partners as general partners if they participated too heavily in management.

In 1977, there was a little-noticed development that ultimately led to a new era in business forms. Wyoming passed a limited liability company (LLC) statute that had everything partneration fans wanted — limited liability for all members, partnership features such as dissolution at will and lack of free transferability, and members' ability to participate in control without risking loss of their limited liability.

The federal government was reluctant, however, to bless the entity with partnership tax treatment. After all, why should the government forego the revenues it could get from the many companies that were willing to trade double taxation for limited liability and other corporate features?

On Nov. 17, 1980, the IRS proposed treating LLCs as cor-

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porations (45 Fed. Reg. 75,709). The IRS eventually withdrew that proposal in 1983, but privately ruled in 1982 that an LLC would be classified as a corporation (PLR 8304138) and announced in 1983 that it would not issue any more private rulings concerning LLC classification (Revenue Procedure 83-15). Though Florida joined Wyoming with an LLC act in 1982, the LLC languished in tax limbo.

Meanwhile, the pressure for partneration grew. The Tax Reform Act of 1986 provided some impetus by reducing the tax advantages of retaining corporate earnings and thereby increasing the tax incentives for partnership.

While LLCs were in abeyance, limited partnerships provided an alternative vehicle for testing tax boundaries. Soon after the temporary defeat of the LLC, the 1985 version of the Revised Uniform Limited Partnership Act was promulgated.

Among other things, Section 303 of the act further eroded the "control rule" by clarifying that creditors could recover from limited partners only if the creditors detrimentally relied on limited partners' exercise of control, and even then only from limited partners whose participation in the business does not fit into a long list of safe harbors. Limited partnerships blurred tax and other distinctions between corporations and partnerships.

In 1988, the IRS made official in Revenue Ruling 88-76 what had become increasingly inevitable by holding that a Wyoming LLC could be taxed as a partnership. Now the partneration floodgates really opened. By the end of 1991, Colorado, Kansas, Virginia, Utah, Texas and Nevada had passed LLC statutes.

LLCs, however, still had to play the tax-classification game. This meant that an LLC that had limited liability also had to be sure that it had no more than one of the other "corporate" characteristics of free transferability, continuity of life, and centralized management.

LLCs also posed uncertainties that tax rules could not solve. LLCs began as basically the offspring of partnerships and limited partnerships, with the addition of full-fledged limited liability. How would courts treat this hybrid?

- Would they respect the limited liability of what were essentially partners in out-of-state LLCs if their own state legislatures had not taken this step?
- What standards would courts in and outside of the state of formation apply in piercing the LLC veil?
- What are managers' and members' powers and duties in manager-managed and member-managed LLCs?
- Could LLCs, like close corporations but unlike partnerships, have only one member?
- Is an LLC like a partnership for bankruptcy purposes?
- Is an LLC interest a "security" for purposes of federal and state securities laws, or an LLC member an employee under employment discrimination and worker compensation statutes?
- Would courts treat LLCs as aggregates of the members, as partnerships still were to some extent, or as corporate-type entities?
- Would courts accord LLC operating agreements the same respect as they did partnership agreements?
- How might the millions of existing partnerships turn themselves into LLCs?

Apart from these legal uncertainties, there were many fewer off-the-rack forms that lawyers could use for LLCs than there were for more established types of firms.

Clarification would come as more LLCs were formed, but who would form LLCs until important issues were clarified? For want of an egg the chicken was lost. Or, to use academics' fancier term, LLCs faced the same sort of problems of getting a "network" going that impedes the spread of all new technologies.

There seemed to be a couple of ways out of this mess. The National Conference of Commissioners on Uniform State Laws could shape LLC law by drafting a uniform law. But NCCUSL, too, was apparently waiting for enlightenment.

Another way to provide clarity for LLCs would be to borrow the partnership "network" of cases and forms by tacking limited liability onto the existing partnership form. In 1991, Texas developed the limited liability partnership (LLP) to ease law firms' transition to limited liability in the wake of the savings and loans crisis of the late 1980s and early 1990s. The LLP form let partnerships get limited liability while otherwise being treated as partnerships. Yet as theoretically attractive as this approach might be, in fact LLPs have remained a niche form, used almost exclusively by professional firms.

The LLC marched on even without fancy prosthetic devices. By 1996, every U.S. jurisdiction had an LLC statute. NCCUSL finally promulgated its Uniform Limited Liability Company Act. Since every statute allowed for foreign LLCs, LLCs clearly could do business nationwide. The IRS, forced to deal with ever more complications under the classification rules, and facing universal acceptance of the LLC

Web site for more information

LNET-LLC: An active limited liability company, partnership and corporation discussion group, with state pages containing important information on state LLC laws. To subscribe, send a message to lnet-subscribe@egroups.com or go to www.eGroups.com/list/lnet.

form, finally gave up trying to put business entities in tax boxes. Under Treasury Regulation 301.7701-1-3, effective Jan. 1, 1997, firms could decide for themselves — that is, "check the box" — whether they wanted to be taxed as partnerships and corporations.

The check-the-box rule took the lid off of the growth of LLCs. Tax returns for the year 2000 report 718,704 domestic LLCs, up from 589,403 in 1999. The 2002 Annual Report of the Jurisdictions of the International Association of Corporation Administrators shows 521,953 domestic and foreign LLCs filing in 43 reporting states for 2001, compared to 474,791 for 2000. While LLC filings were rising by 47,000 from 2000 to 2001, domestic for-profit business and professional corporation filings were dropping about 30,000 and limited partnership filings were dropping about 7,000. These figures indicate that LLCs are gradually replacing corporations and limited partnerships as the leading business entity.

LLCs' spread solved the "chicken-egg" problem with the development of LLC law by establishing a sizable constituency of lawyers and business people who support and provide clarification and refinement. Courts are deciding LLC cases at a rate comparable to or exceeding partnership cases. The courts and regulators have moved toward resolving many of the initially vexing LLC issues, as shown in the sidebar to the right.

State legislatures and bar committees also have adapted LLC statutes to meet current business needs. For example, partly in response to IRC §2704(b), which hinges taxation of intra-family transfers of business organization interests on state statutory exit rights, the vast majority of LLC statutes eliminated the partnership rule permitting members to dissolve or exit at will. State statutes also have evolved toward substantial uniformity with respect to many types of provisions, thereby facilitating nationwide practice even without an official uniform law.

LLCs' growth and spread demonstrates both the folly of trying to predict the future and the need to preserve flexibility. Changing business conditions might cause the LLC to be replaced by some new or hybrid form, just as the LLC seems to be taking over from the close corporation and limited partnership forms.

A good example of the uncertainty of the future is the recent reduction of the dividend tax. What if Congress were to go all the way to eliminating the tax on dividends? Since the partneration arose as a way of combining corporate-type limited liability and partnership-type taxation, will it still be needed once that combination is available in the corporate form? Chances are it will, because even apart from tax considerations, LLCs have evolved to suit the needs of modern closely held firms in ways that the corporate form does not, particularly including contract-based flexibility.

But no one knows for sure what the future might bring.

The recent past shows that our "laboratory" of state laws can develop and refine business forms when the business need arises, notwithstanding seeming tax or theoretical impediments. We can promote this laboratory by keeping the road to the future as free as possible of regulatory and tax potholes. There are also ways to encourage evolution.

In particular, the future, like the past, owes to the work of lawyers in the trenches, both on behalf of clients in individual cases and at the bar and law-reform level. Preserving this dynamic system is a key to this country's continued prosperity. blt

Is it safe to use LLCs?

Are you still afraid to use LLCs because you think they are too new and unpredictable? Rethink this conclusion in light of the following brief summary of the current law:

- The limited liability "veil" gets at least as much respect in LLCs as in corporations. See, for example, *Kaycee Land and Livestock v. Flahive,* 46 P3d 323 (Wyo. 2002).
- An LLC, like a corporation, can do business in every state under its formation state law.
- Every state but Massachusetts allows single-member LLCs.
- Operating agreements are broadly enforceable. For example, in *Elf Atochem N.A. Inc. v. Jaffari,* 727 A.2d 286, 288 (Del 1999) the Delaware Supreme Court said that "only where the agreement is inconsistent with mandatory statutory provisions will the members agreement be invalidated."
- An LLC is a distinct entity for various purposes. To take one of many examples, *Abrahim & Sons Enterprises v. Equilon Enterprises, LLC,* 292 F3d 958 (9th Cir. 2002) held that an LLC was "another person" under a California franchise statute, thus requiring a franchisor to give a first option to buy a leased gas station before transfer to the LLC.
- Many statutes have provisions authorizing conversions between LLCs and other business entities.
- Courts and legislatures have clarified the application of non-LLC law to LLCs, including among many other things the application of federal diversity jurisdiction, the federal securities laws, state securities laws, bankruptcy laws and employment laws. For example, it is now fairly clear that truly member-managed firms are not securities (*Keith v. Black Diamond Advisors Inc.,* 48 F.Supp. 2d 326 (S.D.N.Y. 1999)) while firms in which members have little effective control are securities (*SEC v. Parkersburg Wireless, LLC,* 991 F.Supp. 6 (D.D.C. 1997).

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