Limited Liability Companies

Background

Limited liability companies (LLCs) developed in the 1990s as a very popular form of business in the United States. This form of business is a hybrid of components of partnerships and CORPORATIONS. Like partnerships, LLCs can be managed completely by owners of the business, who are called members. These businesses are now generally taxed in the same category as partnerships, rather than corporations. Owners of an LLC also enjoy limited liability similar to that of a corporation. The LLC business form provides flexibility that is not generally available in other types of business forms, thus making the LLC a favorite of many business owners.

The federal government in 1997 eliminated some tax concerns regarding LLCs with the enactment of so-called "check-the-box" regulations. Owners of LLCs can choose to be taxed as a partnership, which is beneficial because the company itself is not taxed; only the owners themselves must pay taxes. Since the passage of these tax regulations, owners of an LLC could establish a business with management functionally identical to that of a corporation, yet the company will be taxed as a partnership.

Every state now permits the LLC as a business form. The National Conference of Commissioners on Uniform State Laws drafted the Uniform **L**IMITED **L**IABILITY **C**OMPANY Act in 1995, with subsequent amendments that were necessary after the enactment of check-the-box tax regulations. Though only eight states have adopted this act, several states have modified their statues to be consistent with the uniform law. Although LLC statutes are often similar from one state to the next, a person should check the laws governing LLCs in his or her individual state.

Characteristics of Limited Liability Companies

Comparisons with Other Business Entities

Limited liability companies can take a form similar to almost any other business entity. Member-managed LLCs, discussed below, are most analogous to the various partnership forms, including general partnerships, limited partnerships, limited liability partnerships, or limited liability limited partnerships. Manager-managed LLCs, discussed below, may now be formed in every state and are most analogous to corporations. By forming an LLC, members can generally establish the business form that best suits their company, without suffering the drawbacks associated with other business forms, such as lack of limited liability or double TAXATION.

Member-Managed Limited Liability Companies

The DEFAULT form of a limited liability company in most jurisdictions is the member-managed LLC. This is based on the idea that the LLC in its basic form is managed similarly to a partnership, rather than a corporation. Under partnership law, all general partners have an equal right to manage the business, unless the partners agree otherwise in a partnership agreement. Similarly, LLC members generally have equal management rights, unless the members agree otherwise in the articles of organization or the operating agreement. Members in an LLC, like partners in a partnership, also have equal voting rights in several jurisdictions, including those that have adopted the Uniform Limited Liability Company Act. However, some states divide voting rights proportionately based on the financial interests of each of the members. Such an allocation is more similar to voting rights in a corporation. It should be noted that most of the rules regarding management may be modified by the members in the operating agreement. The state laws are often "default" rules that apply in the absence of such an agreement. Members in a member-managed LLC have the authority to act as an agent of the LLC.

Manager-Managed Limited Liability Companies

In a manager-managed LLC, members employ managers to operate the company. A managermanaged LLC must be established in the articles of organization in about half of the states. A managermanaged LLC resembles a corporation, rather than a partnership, because some or all of the owners of the company do not make day-to-day management decisions. These decisions are rather left to agents of the company, some of whom may be members. If an owner serves as a member, but not as a manager, in this form of business, that owner does not generally have the authority to act as an agent of the company.

Formation of Limited Liability Companies

Articles of Organization

To form an LLC, owners must generally file a document called the articles of organization, which are similar to ARTICLES OF INCORPORATION for a CORPORATE form of business. The contents of the articles vary slightly from one state to the next, but generally contain the following information:

- The name of the LLC
- The address of the LLC
- The name and address of the registered agent for service of process
- The name and address of each prospective member of the LLC
- An indication of whether the LLC will exist only for a specific term
- An indication of whether the LLC is manager-managed
- An indication of whether an LLC's members will be personally liable for the debts and obligations of the company

Number of Members in Limited Liability Companies

It is possible to establish an LLC with only one member in most jurisdictions. By comparison, it is not possible to form a single-member partnership, since partnership law contemplates an agreement between two or more persons. An owner of a single-member LLC can enjoy limited liability and will be taxed as a SOLE PROPRIETORSHIP under federal tax laws.

Operating Agreement

While articles of organization are the most basic documents prepared by an LLC, the operating agreement is the focal point of most LLCs. This agreement is similar to a partnership agreement in that it reflects the decisions made by the members of the LLC with respect to the operation of the company. It may contain provisions regarding management and governance of the company, maintenance of capital accounts, compensation and distributions, admission or withdrawal of members, and a number of other provisions. Although the operating agreement is not generally mandatory, it is a necessary document for practical purposes.

Naming a Limited Liability Company

The Uniform Limited Liability Company Act and many states require that an LLC's name include the words "limited liability company" or "limited company," or the abbreviations "L.L.C.," "LLC," "L.C.," or "LC". Such a requirement exists so that individuals and other businesses will know they are dealing with a limited liability entity in a business transaction.

Liability of Limited Liability Companies and Members

Nature of Limited Liability

Providing limited liability to members of an LLC does not completely shield members from any liability. The most basic shield is that members are not personally liable for the debts, obligations, and liabilities of the LLC. Members may agree that some members are personally liable for the debts and other obligations of the company, and the members can include a provision regarding personal liability in the articles of organization. To hold a member personally liable, the member must generally consent in writing to this provision.

In addition to a member consenting to personal liability, members can also be liable in several other instances. The most notable exceptions are as follows:.

- Members are always liable for their own torts, even when members are acting on behalf of the LLC. Thus, for example, if a member is negligent when performing some act for the LLC, and this NEGLIGENCE causes harm to a third party, the member is personally liable.
- Members are liable when they agree to contribute to the LLC. Members may also be required to return money or property to the company if the company is insolvent.
- Members who seek to bind the LLC without the authority to do so may be liable for an obligation created, such as a contract with a third person. The member in such a case will be liable to both the LLC and the third person.
- Members are personally liable in some situations involving collection and payment of employment taxes.

"Piercing" a Limited Liability Company's "Veil"

In laws governing corporations, the protection against personal liability of owners is often referred to as the "veil" of limited liability. Corporation laws permit, in some circumstances, permit third parties to "pierce the veil" of limited liability, usually when owners use the corporate form of business to perpetuate FRAUD. One of the more interesting issues that has arisen with respect to limited liability companies is whether a court could pierce the veil of a limited liability company if the owners of the LLC engage in improper conduct that would allow a corporation's veil to be pierced. This issue has not be completely resolved, though some states now provide provisions permitting the piercing of an LLCs veil on grounds similar to that of a corporation.

Tax Liability of Limited Liability Companies

Prior to January 1, 1997, owners of limited liability companies had to consider their tax classification when they organized their companies. If an LLC were too similar to a corporation, the LLC may have been taxed as a corporation under the former tax regulations (the "Kintner" regulations). The regulations that went into effect in 1997 allow owners of LLCs to select the tax treatment of their company. Under the "check-the-box" regulations, owners of an LLC may elect to be taxed as a partnership even if the business is organized similar to a corporation. Since these tax regulations came into effect, the process of forming an LLC has been simplified, and many states have removed provisions in state statutes governing LLCs that were designed to allow LLCs avoid similarities with corporations.

Duties and Rights of Members of Limited Liability Companies

Fiduciary Duties

If a member of an LLC is also a manager, then that member is in a position of trust. To protect other owners of the LLC, these members owe the LLC the duty of loyalty and the duties of care. The duty of loyalty prevents a member from competing with the LLC in another business. A member must refrain from dealing with a person or business with interests adverse to those of the LLC and account for any benefits received from use of LLC property or from the winding up of LLC affairs. The duty of care requires a member to refrain from grossly negligent, reckless, or intentional misconduct. The duties of loyalty and care are similar in partnership law. Managers of an LLC who are not owners are held to the same standard. However, a member who is not a manager of a manager-managed LLC is not bound by the same FIDUCIARY duties, since such a manager is not involved in the day-to-day activities of the company.

Indemnity and Contribution Rights

The Uniform Limited Liability Company Act provides that a member must be reimbursed for payments made on behalf of the LLC and indemnified for liabilities incurred by the member during the ordinary course of the LLC's business. These rights are similar to those provided to partners in a general partnership. However, most state statutes do not address indemnity rights. Similarly, the ULLCA provides that members are required to make contributions according to the agreement of the owners of the company, which is similar to rights provided in partnership laws. An operating agreement will often set forth such indemnity and contribution rights.

Distributions

The default rules regarding distributions to members differ among the states. Some states provide that members receive a share of distributions in the same proportion as their contributions to the LLC (pro rata distribution). Other states, including those that have adopted the ULLCA, provide for equal distribution among the members (PER CAPITA distribution). These provisions can be altered in the operating agreement.

Transferring Interests

A member may transfer his or her financial rights to profits and losses, and the right to receive distributions, in all states. However, a member cannot transfer full ownership interests, such as those related to the right to manage the company, without unanimous agreement of all of the other members. Rights related to transferability of interests can be modified in the operating agreement.

Dissolution of Limited Liability Companies

In most states, an LLC is dissolved when an event occurs that is specified in the operating agreement: the requisite number of members consents to DISSOLUTION, as provided by the operating agreement; some event occurs that renders the LLC's business unlawful; a term set forth in the operating agreement expires; or a judicial DECREE dissolves the LLC due to misconduct or frustration of an LLC's business purpose. When an LLC dissolves, the winding up process commences. The LLC's assets are liquidated, creditors are paid, and members received distributions in a manner specified by the operating agreement or state law. Once dissolution has occurred, the LLC may file articles of termination with the state, indicating that the LLC is no longer in business.

State Law Governing Limited Liability Companies

Many laws governing limited liability companies are similar from one state to the next. However, some differences exist that could affect the formation or management of a limited liability company. A number of the laws governing LLCs provide default provisions that can be modified by in the organizing agreement of the LLC.

ALABAMA: Alabama adopted the Uniform Limited Liability Company Act in 1999. Articles of organization are filed first with a PROBATE judge in the county in which the registered office of the LLC is located, then with the Secretary of State. Single member LLCs are not permitted. Distributions are made proportionately to the interests of the members by default.

ALASKA: Articles of organization are filed with the Department of Commerce and Economic Development. Single member LLCs are permitted. Distributions are made equally by default.

ARIZONA: Articles of organization are filed with the state's corporation commission. Single member LLCs are permitted. Other provisions are generally governed by operating agreements of the LLCs.

ARKANSAS: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting and distribution rights are generally equal among the members by default.

CALIFORNIA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Third parties may pierce the veil of LLC liability in provisions provided in laws governing corporations. Voting and distribution rights are proportionate with the contributions of members by default.

COLORADO: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Third parties may pierce the veil of LLC liability using the same standards as corporate laws. Distributions are made as agreed by all of the members by default.

CONNECTICUT: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are equal among members by default. Distributions are made based on the value of contributions by each member by default.

DELAWARE: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are equal among members by default. Distributions are proportionate with the contributions of members by default.

FLORIDA: Articles of organization are filed with the Department of State. Single member LLCs are permitted. Under 1999 amendments, the corporate veil piercing doctrine is applied to LLCs. Voting and distribution rights are proportionate with the capital accounts of the members by default.

GEORGIA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting and distributions rights are equal among members by default.

HAWAII: Hawaii adopted the Uniform Limited Liability Company Act in 1999. Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting and distribution rights are equal among members by default.

IDAHO: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting and distribution rights are equal among members by default.

ILLINOIS: Illinois adopted the Uniform Limited Liability Company Act in 1997. Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. The corporate veil piercing doctrine is applied to LLCs by STATUTE. Voting and distribution rights are equal among members by default.

INDIANA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are equal among members by default. Distribution rights are proportionate with the value of the contributions by default.

IOWA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are not permitted. Voting and distribution rights are proportionate with the value of capital contributions by default.

KANSAS: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Distribution rights are proportionate with the value of capital contributions by default.

KENTUCKY: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are equal among members by default. Distribution rights are proportionate with the value of capital contributions by default.

LOUISIANA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are not permitted. Voting and distribution right are equal among members by default.

MAINE: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. The corporate veil piercing doctrine is applied to LLCs by statute. Distribution rights are equal among members by default.

MARYLAND: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are proportionate with members' interests in profits by default. Distribution rights are proportionate with rights to share in profits by default.

MASSACHUSETTS: Articles of organization are filed with the office of Secretary of State. Single member LLCs are not permitted. The decision of members owning more than 50 percent of unreturned contributions controls many of the actions of the LLC. Distribution rights are proportionate with the value of capital contributions by default.

MICHIGAN: Articles of organization are filed with the chief officer of the Department of Commerce. Single member LLCs are not permitted. Voting and distribution rights are proportionate with the value of the capital contributions by default.

MINNESOTA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting and distribution rights are proportionate with the value of the capital contributions by default.

MISSISSIPPI: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are equal among members by default. Distribution rights are proportionate with the value of capital contributions by default.

MISSOURI: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are equal among members by default. Distribution rights are proportionate with the value of capital contributions by default until all members have received the value of their contributions. Once all members have received their contributions, remaining distributions are divided equally.

MONTANA: Montana adopted the Uniform Limited Liability Company Act in 1999. The ability to pierce the veil of an LLC is restricted considerably by statute. Distribution rights are proportionate with the value of capital contributions by default.

NEBRASKA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are proportionate with the value of capital contributions by default.

NEVADA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are proportionate with the value of capital contributions by default.

NEW HAMPSHIRE: Articles of organization are filed with the office of Secretary of State. Single member LLCs are not permitted. Voting rights are equal among members by default. Distribution rights are proportionate with the value of capital contributions by default.

NEW JERSEY: Parties file a certificate of formation with the office of Secretary of State. Single member LLCs are permitted. Voting and distribution rights are proportionate with the value of capital contributions by default.

NEW MEXICO: Articles of organization are filed with the state corporation commission. Single member LLCs are permitted. Voting and distribution rights are proportionate with the value of capital contributions by default.

NEW YORK: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Distribution rights are proportionate with the value of capital contributions. Voting rights are proportionate with members' rights to share profits.

NORTH CAROLINA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted.

NORTH DAKOTA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. The corporate veil piercing doctrine is applied to LLCs by statute. Voting rights are proportionate with the value of capital contributions by default.

OHIO: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Distribution rights are proportionate with the value of capital contributions by default.

OKLAHOMA: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting and distribution rights are proportionate with the value of capital contributions by default.

OREGON: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting rights are equal among members by default. Distribution rights are proportionate with members' shares by default.

PENNSYLVANIA: Articles of organization are filed with the Department of State. Single member LLCs are permitted. Voting and distribution rights are equal among members by default.

RHODE ISLAND: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting and distribution rights are proportionate with the value of capital contributions by default.

SOUTH CAROLINA: South Carolina adopted the Uniform Limited Liability Company Act in 1996. Articles of organization are filed with the office of secretary of state. Single member LLCs are not permitted. Voting and distribution rights are equal among members by default.

SOUTH DAKOTA: South Dakota adopted the Uniform Limited Liability Company Act in 1998. Articles of organization are filed with the office of Secretary of State. Single member LLCs are not permitted. Voting and distribution rights are equal among members by default.

TENNESSEE: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting and distribution rights are equal among members by default.

TEXAS: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Distributions rights are proportionate with the value of capital contributions by default.

UTAH: Articles of organization are filed with the Division of Corporations and **C**OMMERCIAL **C**ODE of the Department of Commerce. Single member LLCs are permitted. Voting and distribution rights are proportionate with the value of capital contributions by default.

VERMONT: Vermont adopted the Uniform Limited Liability Company Act in 1996. Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. Voting and distribution rights are equal among members by default.

VIRGINIA: Articles of organization are filed with the State Corporation Commission. Single member LLCs are permitted. Voting and distribution rights are proportionate with the value of capital contributions by default.

WASHINGTON: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. The corporate veil piercing doctrine is applied to LLCs by statute. The decision of members owning more than 50 percent of unreturned contributions controls many of the actions of the LLC.

Distribution rights are proportionate with the value of capital contributions by default.

WEST VIRGINIA: West Virginia adopted the Uniform Limited Liability Company Act in 1996. Single member LLCs are not permitted. Articles of organization are filed with the office of Secretary of State. Voting and distribution rights are equal among members by default.

WISCONSIN: Articles of organization are filed with the office of Secretary of State. Single member LLCs are permitted. The corporate veil piercing doctrine is applied to LLCs by statute. The decision of members owning more than 50 percent of unreturned contributions controls many of the actions of the LLC. Distribution rights are proportionate with the value of capital contributions by default.

WYOMING: Articles of organization are filed with the office of Secretary of State. Single member LLCs are not permitted. Voting and distribution rights are proportionate with the value of capital contributions by default.

Additional Resources

Agency, Partnership, and the LLC in a Nutshell. Hayes, J. Dennis, West Group, 2001.

Limited Liability Companies: A State by State Guide to Law and Practice. Callison, J. William, and, Maureen A. Sullivan West Group, 2001.

Limited Liability Company Handbook. Sargent, Mark A., and Walter D. Schwidetzky, West Group, 2001.

Uniform Limited Liability Company Act. National Conference of Commissioners on Uniform State Laws, 1996. Available at http://www.law.upenn.edu/bll/ulc/fnact99/1990s/ullca96.htm.

Your Limited Liability Company: An Operating Manual. Mancuso, Anthony, Nolo Press, 1999.

Organizations

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