

The Limited Liability Company Handbook



CT Corporation

The Legal Professional's First Choice

A Comprehensive
Look at the LLC for
Business Owners and
Legal Professionals

THE LIMITED LIABILITY COMPANY HANDBOOK

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Business Owners and Legal Professionals

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INTRODUCTION

The law of business organizations has drastically changed over the past two decades due to the creation and increasing popularity of the limited liability company (LLC). From its humble beginning as a piece of special interest legislation in Wyoming, the LLC has grown into such a popular vehicle that today there are more LLCs being formed and registered each year than corporations.

The limited liability company is a “hybrid” entity, created to provide the liability benefits of a corporation, with the tax benefits of a partnership. The first modern limited liability company was actually created in Germany in 1892. The concept spread throughout Europe and South America, but it was not until 1977 that the first LLC Act was passed in the United States.

The concept did not spread to the other states (other than Florida), because it was not known if the Internal Revenue Service would tax an LLC as a partnership. However, in 1988, the IRS ruled that it would classify a limited liability company as a partnership if the LLC had fewer corporate characteristics than partnership characteristics. Following that ruling the remaining states began to adopt LLC Acts.

Although LLCs became available nationwide, many business people were reluctant to use them because of lingering uncertainty over whether a company with the characteristics they desired would be taxed as a partnership. However, that uncertainty was eliminated in 1997 when the Treasury Department's "check-the-box" regulations went into effect.

Today, use of the LLC is so widespread that any legal professional dealing with start-up or continuing business ventures must be familiar with this type of organization. The purpose of this book is to provide a framework for understanding the limited liability company and the LLC statutes. The reader should understand, however, that this book is intended as a general guide. This book is not a research tool to be consulted in connection with a particular problem. The applicable statute, governing documents, and case law should provide guidance for particular situations. The editors hope that our readers will find this book useful and informative.

CHAPTER 1

FORMS OF BUSINESS ORGANIZATIONS

Choosing a Business Organization

When a person decides to start up a business, one of the first things that person must do is decide which form of business organization to use. There are several types of business entities from which to choose. These include the:

- sole proprietorship
- general partnership
- limited liability partnership
- limited partnership
- corporation
- limited liability company

Which form the business owner chooses will depend upon a number of factors. Among the issues to be considered are the owners' need to limit their personal liability, their desire to control the business, and their tax situation. Each form of business organization has advantages and disadvantages that make it a prudent

means of conducting business in some circumstances, but not in others. The help of a legal professional is essential in evaluating all of the factors upon which the choice of entity is based.

Sole Proprietorship

A sole proprietorship is a business owned and operated by one individual. A sole proprietorship is not an entity separate and apart from its owner. As such, the owner has unlimited personal liability. If the business' assets are not sufficient to meet the business' obligations, the personal assets of the sole proprietor can be used to satisfy those obligations. This is the main disadvantage of doing business as a sole proprietorship.

A sole proprietorship is "disregarded" for federal income tax purposes. The sole proprietorship and owner are considered as one. The owner pays personal taxes on the income earned by the business.

A sole proprietorship is considered the simplest and least expensive type of business to form and operate. No formation documents have to be filed with the state in order to do business. In addition, the sole proprietor can operate the business the way he or she sees fit without having to comply with statutory formalities such as holding meetings or taking minutes.

A sole proprietorship will, however, have to comply with the requirements necessary for the kind of business it will be conducting. Federal, state or municipal laws may require certain licenses, permits or tax registrations. For example, a sole proprietorship operating a restaurant may need a liquor license. A sales tax certificate will have to be obtained if the sole proprietorship engages in activities subject to sales taxes, and a Federal Employer Identification Number will have to be obtained if it will have employees. In addition, if business is conducted under a name other than the owner's, an assumed name filing will have to be made.

General Partnership

If two or more persons agree to do business together, a partnership is formed. No specific state statute is needed to provide authority. Because a general partnership is not a statutory business organization, no filings have to be made for it to exist. Nevertheless, every state has a partnership statute. Most of the provisions of the state partnership laws, however, are default rules. Default rules apply only in the absence of a governing provision in the partnership agreement.

The basic governing document of a general partnership is the partnership agreement. It can be oral or written. However, it is usually considered important to prepare a written partnership agreement.

This agreement usually sets forth the names and addresses of the partners, their rights to management and profits, the requirements for admission of new partners, provisions for dissolution, and any other provision the partners wish to govern their relationship and the operations of the business.

A general partnership does not have to pay an entity level income tax. It is a “flow through” entity. Its profits and losses flow through to the partners. The general partners are also personally liable for the partnership’s debts and obligations. This unlimited liability is considered the biggest disadvantage of doing business as a general partnership.

Limited Liability Partnership

A limited liability partnership (LLP) is a special kind of general partnership. The LLP was created to provide an entity with the simplicity and operational flexibility of a partnership, but without the unlimited liability. The first LLP law was enacted in 1991, and every state has now adopted a law authorizing limited liability partnerships. LLPs are often used by law firms, accounting firms and other professionals. However, in most states, LLPs can be used for any kind of business.

An existing general partnership can become an LLP by filing a statement of registration or qualification

containing basic information about the partnership. When a general partnership becomes a limited liability partnership, no new entity is created, no new partnership agreement is needed, and no transfer of assets has to be made. In many states an LLP may be newly formed without there being a pre-existing GP.

Partners in an LLP enter into a partnership agreement that governs their rights and relationships and the operation of the business. An LLP is also subject to certain statutory requirements such as having to maintain a registered agent and file an annual report. A limited liability partnership doing business in a foreign state is also required to register with the state.

An LLP's partners do not have unlimited personal liability. In most states partners are not liable for any of the LLP's debts—contractual, tort or otherwise. In some states, however, partners are only shielded from liability for the debts arising from the negligence and wrongful acts of the other partners, but are liable for contractual obligations. In all states, partners remain liable for their own malpractice. An LLP is taxed in the same manner as a general partnership.

Limited Partnership

A limited partnership (LP) is a partnership formed under the laws of one state, having at least one general partner and at least one limited partner. The general partners manage the partnership and have unlimited liability for its debts. The limited partners are passive investors who have limited liability. The partners in a limited partnership enter into a partnership agreement that governs their rights and duties and the partnership's affairs. A limited partnership is entitled to flow-through taxation.

A limited partnership is a statutory business organization. As such, it is formed by filing a document, generally known as a certificate of limited partnership. Every state has a limited partnership statute. These statutes contain some mandatory provisions, such as requiring the maintenance of a registered agent and record keeping office, and requiring certain words in the name. They also contain default provisions dealing with the relationships among the partners and the operation of the business that will only apply in the absence of a provision in the partnership agreement. In addition, the laws require limited partnerships formed in other states to register before doing business within the state's borders.

Furthermore, a growing number of states permit the formation of a limited liability limited partnership (LLLP). An LLLP is a limited partnership in which the general partners, rather than having unlimited personal liability for the partnership's debts, have the same liability as partners in an LLP.

Corporation

A corporation is an entity organized for profit under the business corporation laws of one state. It is also known as a business corporation, for profit corporation or stock corporation. A corporation has its own legal existence, separate and apart from its shareholders. It has most of the rights and powers of individuals—including the right to sue and be sued in its own name, incur debts, own and sell property, and enter into contracts.

The corporation is the oldest and most established of the statutory entities. It is also the most expensive and complex to form and maintain. For a corporation's existence to begin, a document, generally called articles of incorporation, must be filed with the proper state office. The corporation also must adopt written bylaws, elect a board of directors, and hold an organizational meeting.

Many of the provisions governing the corporation's internal affairs will be set forth in the bylaws.

However, the affairs of a corporation, more so than any other entity, are governed by the state business corporation act under which it was incorporated.

A corporation is a business entity with the following characteristics:

- Its shareholders have limited liability for the corporation's debts
- It has perpetual duration
- Its shares are freely transferable
- It is managed by, or under the direction of, a board of directors.

A regular or "C" corporation is subject to "double taxation." That is, the corporation pays a tax on its income when earned, and its shareholders pay a tax on the income when it is distributed to them in the form of dividends and upon the dissolution of the corporation. However, an "S Corporation" does not pay income taxes, as its profits and losses pass through to the shareholders. In order to qualify for S corporation tax status, a corporation must meet several requirements. For example, there are limits on the number and identity of shareholders and on the classes of shares.

There are also special types of corporations. They include the nonprofit corporation, professional service

corporation and cooperative corporation. These corporations are generally formed and governed by separate corporation statutes—although the provisions of the business corporation act may apply where there is no conflicting provision of the special statute.

Limited Liability Company

A limited liability company (LLC) is a relatively new form of business entity in this country. It was created to provide an entity that could be taxed as a partnership, while providing its owners with the limited liability of a corporation. It may be a for profit entity or, under many state laws, it may be formed for a nonprofit purpose. It may also provide professional services.

A limited liability company is a statutory entity that requires the filing of a document, generally known as articles of organization, in order to exist. The owners, called members, enter into an operating agreement. This is the basic governing document, which provides for the regulation of the affairs of the company, the conduct of its business, and relations among the members and managers.

The succeeding chapters will deal in some detail with the nature and characteristics, formation, members, management, and other aspects of limited liability companies.

CHAPTER 2

NATURE AND CHARACTERISTICS OF A LIMITED LIABILITY COMPANY

Statutory Business Entity

A limited liability company is a statutory creation. The ability to do business in the LLC form is derived from state law. Unlike a sole proprietorship or general partnership, which may be formed merely by the owner or owners beginning to do business, a limited liability company must follow statutory requirements to begin and continue doing business as an LLC, and to obtain the benefits LLC status brings.

Every state has a Limited Liability Company Act. These Acts apply to companies formed under that state's laws. These are known as domestic limited liability companies. State laws prescribe, for example, what has to be filed to organize, dissolve, or merge a company, and what fees have to be paid. They generally require the maintenance of an agent for service of process and the filing of an annual report. Most acts also have provisions dealing with such

issues as the financial and voting rights of members, the powers and duties of the managers, and the admission and withdrawal of members. However, these are default provisions that can be altered by the members in their operating agreement.

State laws also contain provisions dealing with limited liability companies that do business in their states but that were formed under the laws of another state. These are known as foreign limited liability companies. The laws require foreign LLCs to register with the proper state official. They also prescribe the registration procedure and penalties for doing business without registering.

In general, there is little uniformity among the state LLC statutes. As a result, it is essential to consult each state's act to assess its individual requirements.

Separate Legal Identity

A limited liability company exists as an entity separate and apart from its owners. This means, for example, that an LLC may sue or be sued in its own name, buy, own, and use its own real or personal property, make its own contracts and guarantees, lend money and invest funds, and, in general, have its own rights, responsibilities, and liabilities. Parties doing business

with a limited liability company must look to the company to satisfy any obligations owed to them, and not to the LLC's members or managers.

Limited Liability

One of the key features of a limited liability company is that its owners have limited liability. The individual assets of LLC members may not be used to satisfy the LLC's debts and obligations. A member's risk of loss is limited to the amount of capital invested in the business. However, it is possible that a court may "pierce the veil" and hold a member liable for the LLC's acts if the member completely dominated the company, did not treat it as a separate entity, used the LLC form to perpetrate wrong or injustice, or where it otherwise would be considered unfair to treat the member and company separately. Some acts specifically provide that an LLC's veil may be pierced to the same extent a corporation's may be pierced. However, even in the absence of such a provision, the courts have held that the concept of veil piercing applies to LLCs.

Perpetual Existence

A limited liability company has perpetual existence. An entity is considered to have perpetual existence if a change in its owners does not trigger dissolution. Under most LLC Acts, a limited liability company is only dissolved upon an event specified in the operating agreement, upon the consent of the members, or upon judicial decree. A member's death, retirement, or withdrawal for any other reason is not an event that triggers dissolution and winding up.

In some states, the LLC Act provides that the death or withdrawal of the last remaining member causes dissolution. But even in these states, the LLC can provide that a new member will be appointed to continue the LLC.

Flexible Management Structure

One of the distinguishing features of an LLC is that the members have several options in choosing a management structure. Control over the business and affairs of a limited liability company is vested by statute in the members. However, the LLC may provide that it will instead be controlled by managers. Furthermore, members may also act as managers. Thus, an LLC may be managed by all, some, or none of its owners.

This flexibility means that the LLC may be an appropriate vehicle for ventures with few owners who wish to run the business together (which probably would have operated as a partnership before the creation of the LLC), as well as for a business venture with many owners, spread across the country (which probably would have been operated as a corporation previously).

Free Transferability of Financial Interests

An LLC's ownership interest is called a membership interest. It consists of financial rights and management rights. The members' financial rights include the right to share in the profits and losses and receive distributions from the LLC. These rights are personal property and the default statutory rule is that they may be transferred without restriction. However, the default statutory rule is that there are restrictions on the transfer of the remaining interests—including the right to participate in management. In order for a member to sell or transfer his or her entire interest, including management rights, the consent of all of the remaining members will generally be required—although the operating agreement may provide for less than unanimous consent, or for compliance with any other procedure.

Flow-through Tax Entity

Another characteristic of the limited liability company is that it is a flow-through tax entity, like a partnership or sole proprietorship. This means that the LLC's gains, losses, income, deductions, credits, and other tax items flow-through to the member or members. The member or members take into account their share of the profits, losses and other items in determining their own personal income tax liability. The LLC is not subject to an entity level tax, unless it chooses to be taxed like a "C" corporation.

CHAPTER 3

FORMATION OF LIMITED LIABILITY COMPANIES

Selecting the State of Organization

Once the decision has been made to do business as a limited liability company, one of the next decisions to be made is where to organize. Usually a limited liability company is formed in the state where it will be conducting its business. If it organizes elsewhere, it will have the added expense of registering as a foreign LLC in the state where it is doing business.

Limited liability companies doing business in more than one state sometimes choose to organize in the state where their headquarters will be located. However, they may also choose a different state. Delaware has proven to be a popular state for LLC formation. One of the reasons is because its Act is based on the principal of contractual freedom. In addition, Delaware is known for having an efficient filing office and experienced and knowledgeable business entity lawyers and courts.

After the state of organization has been chosen, the process of organizing the company may begin. This process includes selecting and reserving a name, drafting, executing and filing the articles of organization, and drafting and adopting the operating agreement.

Selecting an LLC Name

One of the first steps in the formation process is selecting the limited liability company's name. There are a number of considerations in choosing an LLC name, such as whether the name is marketable, distinctive, easily remembered and pronounced. However, an LLC cannot simply use any name it wants. The states place restrictions on entity names. These restrictions have to do with required words, prohibited words, and conflicts with the names of other entities.

State laws require LLC names to contain certain words or abbreviations that will indicate what type of business organization it is. For example, the name may have to contain the words "limited liability company" or the abbreviation "LLC" or "L.L.C." Some state laws also place restrictions on the words that can appear in the name. A few laws state that the name may not contain a word indicating that the LLC is used for an unauthorized purpose. Others prohibit the use of words such as "corporation" or "limited partnership" that would imply it is a different kind of entity. Some

require approval of a regulatory agency to use words such as “bank”, “insurance”, “doctor” or “lawyer”.

In addition to requiring and prohibiting certain words, the states provide that the LLC’s name must not conflict with another entity name on record with the business entity filing office. The LLC Act might provide, for example, that an LLC’s name must be distinguishable upon the state’s records from the name of another domestic or foreign LLC, corporation, limited partnership, limited liability partnership, or a reserved, registered, or fictitious name.

Checking Name Availability

Once a name has been selected, its availability may be checked with the business entity department of the state where the company will organize. There are several ways to check whether a name is available. Names can be checked by telephone inquiry to the state filing office, by a written search request, or, in some states, by faxed request. It is usually advisable, when contacting the state, to submit more than one name in case the first choice is not available. The states have also placed their name records on the Internet, and allow users to search the database themselves.

Most business entity departments, in conducting name availability searches, do not check the submitted names against registered federal or state trademarks, or “common-law” trademarks. However, the owners of these trademarks may have a superior right to a name desired by the LLC and may prevent the company from using the name in commerce for similar goods or services. Therefore, a trademark search may be advisable to determine if such a conflict exists.

Name Reservation and Registration

When a name is found to be available, it may be reserved for a limited period of time by filing an application for reservation. This reservation will keep the name available to the LLC until it completes its organization. The reservation period varies from state to state. In some states the reservation may be renewed.

If there are other states where the LLC may do business in the future, it may be advisable to register the name, if the state law provides for this type of filing. A name registration gives an LLC the rights to its name in a foreign state in which it is not yet registered, and prevents others from using it, generally for renewable one year periods.

Articles of Organization

Limited liability companies are formed by filing a document with the secretary of state or other office in charge of business entity filings. In most states the form is called articles of organization.

Each state has its own requirements for the contents of the articles of organization. Typically, however, the articles of organization must set forth at the very least, the limited liability company's name, the name and address of its agent for service of process, and the name and address of organizers. Other matters that may have to be set forth include the LLC's purpose, its duration if less than perpetual, and whether it is to be member-managed or manager-managed.

The LLC Acts also state that optional provisions may be included. However, most provisions regarding the company's business and affairs will be set forth in the operating agreement, rather than the articles of organization.

Execution and Filing of Articles of Organization

Most states provide official articles of organization forms for filing. Some require use of the official form while others make it optional. Some states do not provide documents, thereby requiring the articles

of organization to be drafted based on the statutory requirements.

The articles of organization are executed by the person or persons organizing the company. Generally, the person does not have to be a member or manager. The operating agreement may set forth who is authorized to execute the articles of organization and other official documents.

The limited liability company's existence begins when its articles of organization are filed with the state, unless a delayed effective date is permitted by law and set forth in the articles. After the articles have been completed and executed by the authorized parties, they must be delivered for filing to the appropriate office. Most states require the filing in a central state office such as the secretary of state. Some states have additional requirements, such as a county recording or a publication requirement.

Operating Agreement

Another important step in the formation of a limited liability company is for all of the initial members to enter into an agreement, generally called an operating agreement. In most states the operating agreement may be written or oral. But it is generally considered a good idea to have a written agreement.

Among the issues typically addressed by the operating agreement are:

- The manner of allocating profits and losses and tax items among the members
- Whether voting will be shared equally, based on contributions, or allocated in some other manner
- The vote required to take actions such as electing or removing managers if any, and entering into mergers
- When and how the LLC will be dis-solved
- The rules regarding the admission or withdrawal of members
- The duties and liabilities of those managing the company.

Some LLC Acts state that the operating agreement is optional. However, without an operating agreement, the LLC will be governed by the default provisions of the statutes, which in many cases may not match the desires or meet the needs of the members.

CHAPTER 4

MEMBERS

Membership Status

The term member refers to the individual(s) or entity(ies) holding a membership interest in a limited liability company. The members are the owners of an LLC, like shareholders are the owners of a corporation. Members do not own the LLC's property. They may or may not manage the business and affairs. Initial members are admitted at the time of formation. Consideration for a membership interest may generally consist of any tangible or intangible property including money, promissory notes, services performed or contracts to contribute money or perform services in the future.

Additional members may be admitted upon the conditions set forth in the operating agreement. In the absence of a provision to the contrary, most Acts provide that all of the existing members must consent to the admission of a new member. The operating agreement may also set forth the circumstances under which a member may withdraw, resign, or be expelled from the LLC.

Financial Rights

By virtue of acquiring an interest in a limited liability company, members receive certain financial rights. These financial rights include the right to share in allocations of the company's profits and losses. Members also have the right to share in distributions of the LLC's assets during its existence and when it dissolves and liquidates.

The exact nature of the financial rights, such as whether they will be shared equally, or based on capital contributions or some other criteria, is generally set forth in the operating agreement. The state laws have default provisions stating how these financial rights will be allocated in the absence of a provision in the operating agreement.

Right to Vote

Members of an LLC also have the right to vote. The scope of their voting rights depends upon whether the LLC is being managed by its members or by managers. Members in member-managed companies may vote on all matters affecting the LLC's business and affairs. In a manager-managed company, however, members have limited voting power. They can generally elect and remove managers and vote on certain major

changes such as an amendment to the operating agreement or articles of organization, the admission of a new member, or a merger or dissolution.

Member Inspections

Some states require an LLC to maintain certain records, and provide that members have a right to inspect these records. These records include the names, addresses, contributions, and shares of profits and losses of each member, the names and addresses of managers, and certain tax returns. Other states do not require record maintenance, but provide that members must be given access to information concerning the LLC's business necessary for them to properly exercise their rights and perform their duties.

Dissenters' Rights

Dissenters' rights, also known as the right to an appraisal, is the right to sell a membership interest back to the LLC for the fair value of the interest, if the LLC enters into a transaction that would alter the character of the member's investment, without the member's consent. This kind of transaction would include a merger, a sale of all the company's assets, or a conversion into another kind of entity. Some LLC Acts specifically grant members dissenters' rights,

while others do not. Some Acts provide that the LLC may grant this right in the operating agreement. If dissenters' rights are granted, the procedure the members have to follow to assert the right should be set forth in the operating agreement.

Derivative Suit

Members may also have the right to bring a derivative action. This is a suit brought by a member on behalf of the LLC to protect it from wrongs committed against it by management or others. Although the suit is brought by the member, the action belongs to the LLC. As a result, if the member wins the lawsuit, the damages awarded by the court will go to the LLC. There are certain prerequisites that a member must meet in order to maintain a derivative suit. These include having been a member at the time the alleged wrong was committed and having first demanded that the LLC bring the suit itself.

Some statutes specifically provide members with the right to bring a derivative suit. Where the statute is silent a member may, or may not have a common law right. It is up to the state's courts to decide that.

Liability of Members

Members are not liable for an LLC's debts or obligations. Members are, however, obligated to make required capital contributions. The operating agreement may set forth the penalties for failing to do so. A member who votes for an unlawful distribution is personally liable to the LLC for the portion of the distribution that exceeds the maximum amount that could have been lawfully distributed.

A member in a member-managed LLC, or a member who is also a manager, may be held liable for breaching the fiduciary duties owed to the company and its members. Members may also be held liable for breaching a provision of the operating agreement—such as by withdrawing without following the procedures set forth in the agreement.

CHAPTER 5 MANAGEMENT

Member-Managed or Manager-Managed

An LLC is unique in that, by statute, it may choose one of two management structures. The LLC Acts state that management of the business and affairs of an LLC is vested in its members. However, by providing in its articles of organization or operating agreement (depending upon the state), the LLC may state that it is to be managed by managers.

Whether the LLC's principals will choose member-management or manager-management depends upon a number of factors. These include how many members there are, their relationship to each other, their expertise in the type of business being operated, the size of the business, and the complexity of the operations.

Management by Members

In a member-managed LLC, every member is an agent of the LLC for the purpose of conducting its business and affairs. Every member also has an equal right to manage the LLC's business, unless otherwise provided

in the operating agreement. An LLC may be set up with different classes of members, with one class having greater or different management rights than the others.

The operating agreement will also generally set forth the vote required to take actions on the LLC's behalf. Most Acts have default provisions addressing this issue. They typically provide that a majority vote of members is required for making most business decisions, with certain major decisions requiring a unanimous vote. Unanimity is often required for:

- An amendment of the operating agreement or articles of organization
- The making of interim distributions
- The compromise of a member's obligation to make a contribution for his or her interests
- The admission of a new member
- Consent to dissolve the company
- Consent to merge or convert.

Other management details, such as when and where meetings are to be held, and requirements as to quorum or notice, should be set forth in the operating agreement as well. Members also may appoint officers and delegate to them the right to run the daily

operations, while the members set policy and make major decisions. If there are officers, their duties will generally be set forth in the operating agreement.

Management by Managers

Management of an LLC may also be vested in one or more managers. With this option, the LLC may be managed like a corporation, with a central governing body deliberating and then acting on the LLC's behalf, without having to obtain the members' consent first. The managers may run the day-to-day operations, or they may appoint officers to do that, while they set policy and make fundamental decisions.

Managers are generally admitted as provided in the operating agreement. They may resign at any time, unless otherwise provided. The exact number of managers, or a minimum and maximum number, may be set forth in the operating agreement. Qualifications for managers may also be set forth. Unless otherwise provided, managers may, but need not be members.

Most management details are set forth in the operating agreement. These details would typically include where meetings will be held, quorum, voting, and notice requirements, whether participation by teleconference is allowed, whether committees may be formed, and how vacancies will be filled. Some states have detailed default provisions dealing with meetings,

voting and other management issue. Others have very few default provisions dealing with these matters.

Fiduciary Duties

The people managing an LLC, whether they are members or outside managers, owe special duties to the LLC and its members called “fiduciary duties”. Most LLC Acts have a provision defining those fiduciary duties. However they differ significantly. In general, however, a member in a member-managed company, and a manager in a manager-managed company owe the LLC and its members the duty of loyalty and duty of care. These duties would, for example, prevent the member or manager from profiting at the LLC’s expense, competing with LLC, making less than fully informed decisions, and engaging in grossly negligent or reckless conduct. Some LLC Acts also provide that fiduciary duties may be modified, restricted or eliminated in the operating agreement.

Liability of Managers

Managers are not personally liable for the limited liability company’s debts and obligations solely by reason of their status as managers. However, while managers are not liable to third parties, they may be held liable to the LLC or its members. For example, a manager may be liable for a breach of fiduciary duty,

a breach of the operating agreement, or for voting for an unlawful distribution of the LLC's assets.

Indemnification

Indemnification provides those managing a limited liability company with financial protection against expenses and liabilities incurred in defending themselves against claims based on conduct undertaken in their official capacity, by requiring or permitting the company to provide reimbursement.

Many LLC Acts have a provision dealing with indemnification. Some have a general statement that an LLC must indemnify members or managers for liabilities they incurred in the ordinary course of the business of the company. Others require indemnification where the manager or member was successful on the merits of a lawsuit, and permit indemnification where the person lost the lawsuit, but was found to have acted in good faith and for a purpose reasonably believed to be in the LLC's best interests.

Other statutes do not specifically require the LLC to provide indemnification, but instead state that the LLC has the authority to indemnify its managers and members. In these states, the LLC may set forth the circumstances under which it will indemnify managers and members in its operating agreement.

CHAPTER 6

CHANGES IN LIMITED LIABILITY COMPANY STRUCTURE

Mergers

A merger is a combination of two or more business entities in which the assets, businesses, and liabilities of all of the entities are transferred to one, which continues to exist, while all other entities disappear.

An LLC may enter into a merger for a number of reasons. They include to acquire or sell a business, to reorganize its operations, to change to a different entity type, or to change its state of organization.

An LLC may merge with or into another domestic or foreign LLC. This is known as a “like-entity” or “same-entity” merger. An LLC may also merge with or into another type of business entity. This transaction is known by several names, including a “cross-entity” or “multi-entity” merger. The statutes vary somewhat in how they define “other business entities”. Most, however, have a broad definition and allow LLCs to

enter into mergers with domestic or foreign corporations, general partnerships, limited partnerships, limited liability partnerships and other organizations.

Effecting a Merger

The statutory procedure for entering into a merger generally calls for the LLC to adopt and approve a plan of merger. The required contents of the plan are set forth in the statute. In general, the plan must at least contain the terms and conditions of the merger and the manner and basis for converting the interests of each party to the merger into interests or obligations of the survivor or into money or other property.

The plan must then be voted on by the members. The operating agreement may provide for the number or percentage of members that must vote in favor of a merger for it to be approved. In the absence of a provision in the operating agreement, the statutory default rule will apply. If there are foreign LLCs or other entity forms involved in the merger, they must approve the plan as required by their governing law and documents.

Following approval of the plan, articles of merger or a certificate of merger must be filed with the state filing officer. The merger takes effect when this document is filed, or upon a later effective date that may be set forth in the document.

Conversion

State LLC Acts have provisions authorizing an LLC to convert to another business entity and/or authorizing another business entity to convert to a limited liability company. A conversion is a statutory transaction in which one type of business entity becomes a different type of business entity—such as an LLC becoming an LP. In a conversion, all assets, property, debts, and liabilities of the converting entity vest in the converted entity. The converted entity is for all purposes the same entity as existed before the conversion, just in a different form.

Effecting a Conversion

Although a conversion involves only one entity, it involves two entity statutes—the one governing the converting LLC or other entity, and the one governing the entity into which it will convert. It is important to check both statutes—to make sure they each authorize the proposed conversion and to find out what steps have to be taken to effect the transaction.

In general, an LLC may convert to another business entity by approving a plan of conversion that contains the terms and conditions of the conversion and the manner and basis of converting the membership interests into interests of the converted entity. The members must approve the plan. Then the converting LLC must file articles of conversion. If the LLC is converting to a statutory entity such as a limited partnership or corporation, it will have to file a formation document.

If another business entity wants to convert to a limited liability company, the laws generally state that the entity must take all steps required by the laws of its jurisdiction of formation and by its constituent documents, and then file articles of conversion and articles of organization with the state.

Amendments

Any limited liability company may, within statutory guidelines, amend its original articles of organization by adding a new provision, modifying an existing provision, or deleting a provision in its entirety.

The only limitation is that the new provisions must be ones that could lawfully be contained in the articles of organization at the time of the amendment.

Some Acts specifically require an amendment to be made upon the happening of certain events—such as a change of name or the latest date of dissolution. Others state that an amendment must be made upon an occurrence that makes any of the information in the articles of organization false or inaccurate. The amendment procedure, such as the vote required for approval, is generally set forth in the operating agreement. For the amendment to be effective, the LLC will have to file articles of amendment, signed by an authorized person.

Procedures for amending the operating agreement are generally set forth in the operating agreement. Some states have default rules requiring a vote of all members to amend the operating agreement.

Restatements

Many LLC Acts permit the filing of articles of restatement. Articles of restatement allow the company to restate into a single integrated instrument, all of the provisions of its articles of organization currently in effect. A restatement is particularly useful where the articles of organization have been amended several times, thereby making it difficult to tell which provisions are actually in effect and expensive when certified copies of the articles of organization and all amendments thereto must be obtained from the state.

Corrections

Most states permit the filing of articles of correction if the articles of organization contained an inaccurate statement when originally filed or were defectively signed. Corrections have the advantage of relating back to the effective date of the original articles of organization. Many states also permit articles of corrections to be filed to correct documents in addition to the articles of organization.

Dissolution

The LLC Acts have provisions setting forth the events that will cause the dissolution and winding up of an LLC. They often include the happening of an event specified in the articles or operating agreement. Thus, for example, an LLC may be formed for one business venture only, and the operating agreement may require dissolution after the venture is completed.

An LLC may also be dissolved upon the consent of the number or percentage of members specified in the operating agreement (or, in the absence of a provision in the operating agreement, by the statutory default provision).

After the happening of an event causing dissolution, the limited liability company's existence continues only for the purpose of winding up its business. At

any time after dissolution and winding up, a limited liability company may terminate its existence by filing a document, generally called articles of termination or articles of dissolution. The LLC's existence terminates upon the filing of the articles or upon a later effective date if specified in the articles. In some states the articles must be accompanied by proof that all taxes have been paid. Some states require a filing of a notice of dissolution at the time the winding up begins.

Administrative Dissolution

An LLC may be administratively dissolved by an act of the state filing office. Once administratively dissolved, the LLC may not carry on any business other than that necessary to wind up and liquidate its affairs and notify claimants. The grounds for administrative dissolution vary by state, but generally include a failure to pay any fees, taxes, or penalties due or deliver its annual report within a certain period of time after the due date. The failure to maintain an agent for service of process or notify the state of a change in agent are also grounds found in a number of statutes.

Many LLC laws also provide that an administratively dissolved company may apply for reinstatement. In its application, the LLC must state that the grounds for dissolution no longer exist. Under some laws, there are a limited number of years after administrative

dissolution that reinstatement is possible. When reinstatement is effective, it relates back to and takes effect as of the effective date of the administrative dissolution and the company may resume its business as if it had never been dissolved. However, if another entity formed or registered under its name while it was dissolved, the LLC may have to choose another name when reinstating.

CHAPTER 7

TAX AND REPORTING REQUIREMENTS

Federal Corporate Income Tax

An LLC may be taxed for federal income tax purposes like a C corporation, an S corporation, a partnership, a sole proprietorship or a division. The tax regulations contain default classifications under which an LLC with two or more members will be taxed as a partnership, and an LLC with one member will be disregarded as an entity. However, the LLC can change its classification to a corporation by filing a form with the IRS called "Entity Classification Election."

If an LLC is taxed as a partnership or a disregarded entity, its tax items will flow-through to the member or members and the LLC will not have to pay an entity level tax.

If the LLC elects to be taxed as a C corporation, it will be taxed as an entity. The LLC will have to file a federal tax return and pay taxes on income it earned. It will also be subject to double taxation because, in addition to its income being taxed at the entity level, any profit distributed to the members will be taxed again as personal income.

State Income Taxes

Most states follow the classification that the limited liability company has elected for federal income tax purposes. Thus, for example, if the LLC is taxed like a partnership for federal purposes, it will be taxed like a partnership for state purposes, and will not have to pay state income taxes. Similarly, if a limited liability company has chosen to be classified as a corporation for federal purposes, it will be a corporation for state purposes and will have to pay state income taxes.

Withholding and FICA

A limited liability company that has employees may be required to withhold federal income tax from its employees' wages. The amount withheld depends upon several factors including the amount of wages paid and the number of exemptions the employee claimed. In addition, the Federal Insurance Contributions Act (FICA) commonly referred to as "social security," requires both employers and employees to contribute a stated percentage of wages. The employee portion must be withheld by the employer from each payment of taxable wages until a designated amount of taxable wages has been reached.

Limited liability companies withholding income and/or FICA taxes from their employees must file a return and deposit the withheld tax with an authorized bank.

The LLC is also required to furnish each employee with an annual statement of wages paid and taxes withheld during the previous calendar year.

A limited liability company employing people in states with an income tax must withhold tax from its employees' wages and similarly remit the withheld taxes to the state.

Franchise Tax

In many states, a limited liability company is subject to taxation by reason of its status as a limited liability company. This kind of tax is referred to as a franchise tax.

In some states, this tax may be referred to by another name, such as a license, privilege, excise, or registration tax or fee. Whatever the name, the essence of this kind of tax is that it is levied on a privilege granted by the state, and not on the actual exercise of that privilege.

The basis of the tax varies from state to state. Some impose a flat fee and some a fee based on the number of members. Other bases include the LLC's capital accounts or income or the members' distributional share. The failure to pay a state's franchise tax in a timely manner may subject the LLC to severe penalties including administrative dissolution.

Annual LLC Report

In most states, a limited liability company is required to file an information report. In general, the report must be filed annually and with the secretary of state or other business entity filing officer. However, in some states there is a biennial requirement, and in some states the report is filed with the revenue department instead of the business entity department. The main purpose of an annual report requirement is to provide the public and the state with current information about an entity that they may need to communicate with or locate.

The annual report typically contains basic information about the LLC such as its name, principal office address, name and address of agent for service of process, and names and business addresses of the individuals managing the company. The annual report is an important requirement to be aware of, because, in general, a failure to file within a stated period of time is grounds for administrative dissolution or revocation.

Property Taxes

A limited liability company that owns or uses property may have to pay property taxes.

There are three types of property that may be taxed—real property, tangible personal property, and intangible personal property. Real property includes land and any buildings, structures, improvements or other fixtures on the land. Tangible personal property means any tangible thing that is subject to ownership. Intangible personal property is property not valuable in and of itself, but representing a particular value.

Real property is taxed in all states. Many states tax tangible personal property. Fewer states also tax intangible personal property. The tax is based on the value of the property. A state may only impose a property tax on property whose tax situs—or location—is considered within the state.

Sales and Use Taxes

Most states have sales and use taxes. These are taxes imposed upon the gross amount involved in certain transactions—particularly, the retail sale of various types of tangible personal property. Use taxes are imposed upon the use, storage, or consumption of tangible personal property not subject to the sales

tax. The use tax rate is the same as the sales tax rate. In addition, many counties and cities impose their own sales and use taxes

Sales and use taxes must be paid by the consumer. However, it is the retailer's responsibility to collect the tax and remit the amount collected to the state. Retailers are also generally required to obtain a license or permit before doing business in the state.

CHAPTER 8

FOREIGN LIMITED LIABILITY COMPANIES

Transacting Business

An LLC is a domestic company in one state—its state of organization. It is considered a foreign company in every other jurisdiction. If an LLC wants to transact business in a state other than its state of organization, it will have to register as a foreign LLC with that other state’s business entity filing office.

Not every activity a limited liability company engages in constitutes “transacting business”. Most state LLC Acts list activities that are not considered transacting business, and that a foreign LLC may engage in without having to register. Generally, these lists include engaging in litigation, holding meetings of members or managers, conducting internal affairs, maintaining bank accounts, selling through independent contractors, creating, acquiring, or collecting debts, engaging in a single or isolated transaction, and transacting business in interstate commerce.

Consequences of Transacting Business Without Registering

A limited liability company transacting business in a foreign state may not bring an action in the foreign state's courts until it registers. In addition, a foreign limited liability company doing business in a state before registering may be subject to a monetary fine. The theory behind the penalties is that an unregistered foreign limited liability company should not be able to reap the same benefits and protections given a domestic or registered foreign LLC, without having to pay for those benefits and protections.

Most Acts provide that an LLC's failure to register will not impair the validity of its contracts or acts, prevent it from defending an action in the state or waive the liability limitation of its members or managers. In addition, once the previously unregistered foreign limited liability company registers and pays any penalties due, it may enjoy the same rights, privileges and protections afforded any other domestic or registered foreign limited liability company.

Name

In most states, a foreign LLC's name will have to be distinguishable from the names of other business entities already on record. Consequently, before filing registration documents, the availability of the LLC's

name should be checked with the foreign state. If the LLC's name is found to be available, it should be protected so that no other entity can take the name before registration. This can be done through a name reservation, or in some states, a name registration.

If the foreign LLC's name is not available due to a conflict, the LLC may be required to register under and use a fictitious name. A fictitious name must be available in the state. Some states require the LLC to file a copy of the resolution of its managers or managing members, adopting the fictitious name. The foreign LLC may also be able to use its name in case of a conflict if the entity that owns the name consents and agrees to change its name, or if the LLC has merged with the owner or has acquired its assets, including the name.

Registration

Registration is the procedure a limited liability company must follow to obtain the authority to do business in a foreign state. Registration requires the filing of a document, generally called either an application for certificate of authority or an application for registration, executed by an authorized person.

The required content varies, although the application generally includes the LLC's name, date and jurisdiction of organization, principal office address, name and address of agent for service of process, and names and addresses of the managers if any.

In most states, the application must be accompanied by evidence that the LLC was validly formed and is in good standing in its state of organization. Some of the states also require the good standing document to be dated within a short period of time before filing the application for registration. The period can range from one to six months or longer depending upon the state.

Amended Registration Document

A foreign LLC may be required to file an amendment to its certificate of authority or registration. Some Acts require an amendment to be filed when facts have changed making any statement in the original document false. Others require the certificate of authority or registration to be amended upon specific changes such as a change in name. In some states, the company may also have to file evidence of the change from the state of organization.

Change of Registered Agent

Most states require a foreign LLC to appoint and maintain a registered office and registered agent in the state. The name of the registered agent and the address of the registered office are set forth in the application for registration or certificate of authority. The foreign state must be notified of a change in the agent or address. In most states, notice is given by filing a statement of change of registered agent or office. In some, an amendment to the registration document must be filed. If a new registered agent is being appointed, some states require the new agent's consent to be on the document.

Cancellation of Authority

An LLC that stops doing business in a foreign state can cancel its authority to do business there. Although an entity is not required to cancel its authority in a foreign state when it stops doing business there, it is to the entity's advantage to do so, as it will remain subject to the state's franchise tax, annual report, and other requirements until it is canceled. To cancel its authority, a certificate of cancellation is filed. In some states the foreign LLC may also have to state, or prove, that it has no outstanding tax liability in the state.

If the LLC is dissolved in its home state, or merged out of existence, it will have to be removed from the records of all of the foreign states in which it was registered. In some states, the foreign LLC must follow the same cancellation procedure required of LLCs that have merely stopped doing business. However, other states require the LLC to file a certificate of fact or a certified copy of the merger or dissolution documents that were filed in the formation state.

Revocation of Authority

A foreign LLC's authority to do business in a state may be revoked by the administrative act of the state filing officer, if it fails to comply with certain statutory requirements. Grounds for revocation vary from state to state. They often include a failure to pay fees, taxes, or penalties owed, a failure to deliver an annual report in a timely manner, and a failure to appoint and maintain an agent for service of process or file a statement of change of agent or address. Under the laws of most states, an LLC that has been administratively revoked may apply for reinstatement. However, the application may have to be made within a certain number of years after revocation.

GLOSSARY

Administrative Dissolution — Dissolution of a limited liability company by an act of the state department in charge of business entities, caused by the LLC's failure to comply with certain statutory requirements.

Agent for Service of Process — An agent, required to be appointed by a limited liability company, whose authority is limited to receiving process issued against the limited liability company. Also known as a registered agent or a resident agent.

Amendment — An addition to, deletion from, or a change of existing provisions of the articles of organization or operating agreement of a limited liability company.

Annual Report — A required annual filing in a state, giving information about the limited liability company.

Application for Certificate of Authority — The name of the form filed in many states to register a limited liability company to transact business as a foreign limited liability company. Known in some states as an application for registration.

Articles of Organization — The title of the document filed in many states to create a limited liability company.

Assumed Name — A name other than the true name, under which a limited liability company conducts business. Also referred to as a fictitious name or a trade name.

GLOSSARY

Cancellation — The statutory procedure whereby a foreign limited liability company obtains the consent of a state to terminate its authority to transact business there.

Certificate of Good Standing — Certificate issued by a state official as conclusive evidence that a limited liability company is in existence or authorized to transact business in the state. Also known as a certificate of existence.

Check-the-Box Rule — Federal tax regulation under which an unincorporated organization is taxed by default like a partnership or sole proprietorship but that allows the organization to elect to be taxed like a corporation.

Constituent — A party to a transaction; a limited liability company involved in a merger.

Conversion — A transaction in which one type of business entity becomes a different type of business entity.

Corporation — An artificial entity created under and governed by the laws of its state of incorporation.

Derivative Suit — A lawsuit brought by a member on behalf of a limited liability company to protect the limited liability company from wrongs committed against it.

Dissenter's Rights — A right granted to members that entitles them to have their membership interest appraised and purchased by the limited liability company if it enters into certain transactions of which they do not approve. Also known as appraisal rights.

GLOSSARY

Distribution — A transfer of money or other property made by a limited liability company to a member.

Fictitious Name — A name a foreign limited liability company must register under if its true name is unavailable for use in a foreign state.

Fiduciary Relationship — Relationship in which one party (the fiduciary) must act in good faith and with due regard to the best interests of the other party or parties.

Franchise Tax — A privilege tax levied upon a limited liability company's right to exist or do business as a limited liability company in a particular state.

Indemnification — Financial protection provided by a limited liability company to its members and managers against expenses and liabilities incurred by them in lawsuits alleging that they breached their duty in their service to or on behalf of the LLC.

Limited Liability Company — A statutory entity formed under the Limited Liability Company Act of one state, containing some of the features of a corporation and some of the features of a partnership.

Limited Liability Limited Partnership — A limited partnership in which the general partners do not have unlimited liability for the limited partnership's debts and liabilities.

GLOSSARY

Limited Liability Partnership — A general partnership that registers with a state and whose partners do not have unlimited liability for the partnership's debts and liabilities.

Limited Partnership — A statutory form of partnership consisting of general partners who manage the business and are liable for its debts, and limited partners who invest in the business and have limited liability.

Management — The members of a member-managed limited liability company or the managers of a manager-managed limited liability company.

Managers — The individuals appointed or elected to manage a manager-managed limited liability company.

Members — The holders of ownership interests in a limited liability company.

Merger — The statutory combination of two or more business entities in which one of the business entities survives and all others cease to exist.

Officers — Individuals appointed by the members or managers who are responsible for carrying out the members' or managers' policies and for making day-to-day decisions.

Operating Agreement — The regulations of a limited liability company that provide the basic rules for the conduct of the limited liability company's business and affairs and the relationships among the members and managers.

GLOSSARY

Organization — The act of creating or organizing a limited liability company.

Organizers — The persons who perform the act of organizing a limited liability company.

Partnership — A non-statutory form of business organization in which two or more persons agree to do business together. Also known as a General Partnership.

Registration — The filing of required documents by a foreign limited liability company to secure a certificate of authority to conduct its business in a state other than the one in which it was organized.

Registration of Name — The filing of a document in a foreign state to protect the limited liability company's name, often in anticipation of registration in the state.

Reinstatement — Returning a limited liability company that has been administratively dissolved or had its certificate of authority revoked, to good standing on a state's records.

Reservation of Name — A procedure that allows a limited liability company to obtain exclusive use of a name for a specified period of time.

Restated Articles of Organization — A document that combines all currently operative provisions of the limited liability company's articles of organization and amendments thereto.

GLOSSARY

Sole Proprietorship — An unincorporated business with a sole owner.

Voting Rights — Rights of members to vote their interests pursuant to provisions of the statute and operating agreement.

Winding Up — The discharging of a limited liability company's liabilities and the distributing of its remaining assets to its members in connection with its dissolution.



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