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Annual Survey of Virginia Law: The Virginia Limited Liability Company Act

S. Brian Farmer

Louis A. Mezzullo

THE VIRGINIA LIMITED LIABILITY COMPANY ACT

*S. Brian Farmer**
*Louis A. Mezzullo***

I. INTRODUCTION

Since the passage of the sixteenth amendment[1] in 1913 and the income tax legislation adopted thereunder,[2] the development of new forms of business entities has been driven largely by the desire to harmonize two goals: limited liability for the owners of the entity and pass-through treatment of the entity for income tax purposes.[3]

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* Associate, Mezzullo & McCandlish, Richmond, Virginia; B.A. 1984, J.D. 1987, University of Virginia. Mr. Farmer assisted Mr. Mezzullo in his service on the Joint Committee on Limited Liability Companies of the Business Law and Taxation Sections of the Virginia Bar Association.

** Director, Mezzullo & McCandlish, Richmond, Virginia; B.A. 1967, M.A. 1976, University of Maryland; J.D., 1976, The T.C. Williams School of Law, University of Richmond. Mr. Mezzullo served on the Joint Committee on Limited Liability Companies of the Business Law and Taxation Sections of the Virginia Bar Association. The Committee drafted the bill that became the Virginia Limited Liability Company Act.

1. U.S. CONST. amend. XVI.

2. The first federal income tax legislation was included in the Revenue Act of 1913, ch. 16, 38 Stat. 114.

3. For example, the business trust, also known as the Massachusetts trust, was a popular business entity in the early part of this century because it was believed to provide limited liability while avoiding taxation as a corporation. Its use faded due to the refusal of courts in several states to recognize its limited liability and the United States Supreme Court's holding in Morrissey v. Commissioner, 296 U.S. 344 (1935), that such a trust was taxable as a corporation. *See* Note, *The Real Estate Investment Trust in Multistate Activity*, 48 VA. L. REV. 1125, 1126 (1962).

In 1960, Congress revived this entity in the real estate context by granting partial pass-through income tax treatment to qualifying real estate investment trusts ("REIT"). *See* Pub. L. No. 86-779, § 10(a), 74 Stat. 998 (1960). However, the numerous requirements for qualifying as a REIT, including that beneficial ownership in the REIT be held by 100 or more persons for at least 335 days of every 12-month taxable year, have prevented it from gaining popularity comparable to the limited partnership. I.R.C. § 856(a)(5), (b) (1988); *see also* Treas. Reg. §§ 1.856-1(c) (as amended in 1981). REITS are still recognized under the Internal Revenue Code. *See* I.R.C. §§ 856 to 858 (1991).

Following a recommendation by President Eisenhower that legislation be passed to eliminate the influence of federal income on choice of entity decisions by small businesses, Tax Recom. No. 16, Budget Message of Jan. 21, 1954, H.R. Doc. No. 264, 83d. Cong., 2d Sess., 100 CONG. REC. 571 (1954), *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 1567, Subchapter S was added to the Internal Revenue Code in 1958, allowing a corporation which qualified as a "small business corporation," now known as an "S corporation," to elect to be

On July 1, 1991, the latest product of that development, the limited liability company (referred to herein as an "LLC"), arrived in Virginia. The Virginia Limited Liability Company Act[4] ("Act") became effective on that date, authorizing the organization and operation of LLCs in Virginia. The LLC is a hybrid entity, borrowing from both the corporate and partnership models in attempting to reconcile these two goals. Due to the LLC's hybrid nature, its use at present will be attended by uncertainty on several legal fronts. However, if these uncertainties are resolved, the LLC could become the entity of choice for many types of businesses.

Virginia is not the first state to enact an LLC statute. Wyoming pioneered the LLC in 1977.[5] Florida followed in 1982.[6] However, the LLC did not generate significant interest until 1988. In that year, the Internal Revenue Service ("IRS") issued Revenue Ruling 88-76,[7] which classified an LLC formed under the Wyoming Act as a partnership for federal income tax purposes. With increased certainty that an LLC could avoid the entity-level taxation imposed on Subchapter C corporations,[8] interest in the LLC was rekindled. Colorado and Kansas passed LLC statutes in 1990.[9] Virginia became the fifth state to authorize LLCs, followed closely by Utah, Nevada, and Texas.[10] LLC legislation has been proposed or is be-

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treated in a pass-through manner similar to a partnership. *See* Pub. L. No. 85-866, § 64, 72 Stat. 1606 (1958). Subchapter S was completely revised by the Subchapter S Revision Act of 1982 to eliminate many of the technical requirements which had resulted in inadvertent termination of S corporation elections, and to otherwise make the S corporation more appealing from a tax perspective. *See* Pub. L. 97-354, 96 Stat. 1669 (1982). Because the S corporation is an ordinary corporation for state law purposes, it provides limited liability in addition to pass-through income tax treatment. *See infra* notes 187-206 and accompanying text for a comparison of the tax treatment of the LLC and the S corporation.

4. VA. CODE ANN. §§ 13.1-1000 to -1069 (Cum. Supp. 1991). Delegate Alan A. Diamonstein of Newport News was the primary sponsor of the legislation. LLC legislation was originally introduced in the General Assembly's 1990 session, but was carried over for further study. The 1991 bill was drafted by the Joint Committee on Limited Liability Companies of the Business Law and Taxation Sections of the Virginia Bar Association.

5. Wyoming Limited Liability Company Act, WYO. STAT. §§ 17-15-101 to -136 (Cum. Supp. 1991). The Wyoming Limited Liability Company Act is referred to herein as the "Wyoming Act." The limited liability statutes of other states are referred to herein in a corresponding manner.

6. Florida Limited Liability Company Act, FLA. STAT. §§ 608.401 to .411 (Supp. 1991).

7. Rev. Rul. 88-76, 1988-2 C.B. 360.

8. A corporation governed by Subchapter C of the Internal Revenue Code is referred to herein as a "C corporation."

9. Colorado Limited Liability Company Act, COLO. REV. STAT. §§ 7-80-101 to -913 (Cum. Supp. 1990); Kansas Limited Liability Company Act, KAN. STAT. ANN. §§ 17-7601 to -7651 (Supp. 1990).

10. Utah Limited Liability Company Act, UTAH CODE ANN. §§ 48-2b-101 to -156 (Cum.

ing studied in several other states.[11] While there has not yet been a proposal for a model LLC act along the lines of the model acts for other business entities, the Scope and Programs Committee of the National Conference of Commissioners on Uniform State Laws has approved appointment of a study committee to determine whether drafting a uniform LLC act is warranted.[12]

Although the concept of the LLC as a corporate-partnership hybrid is embodied in all LLC statutes, the specific provisions of these statutes often vary markedly from one another. In Virginia, the drafters of the Act sought an LLC statute that achieved two goals. The first goal was to insure that an LLC formed pursuant to the Act would be characterized for income tax purposes as a partnership under the analysis provided in Revenue Ruling 88-76. As discussed below, this goal was reflected most particularly in the provisions of the Act relating to transfers of interests in and dissolution of the LLC.

The second goal was to allow maximum flexibility within the parameters imposed by income tax considerations and public policy in customizing an LLC's managerial and financial structure. Accordingly, the Act's provisions governing these matters reject the procrustean approach of statutory dictates found in the Virginia Stock Corporation Act ("VSCA").[13] Instead, they imitate the Virginia Revised Uniform Limited Partnership Act ("VRULPA")[14] and the Virginia Uniform Partnership Act ("VUPA")[15] by, in many instances, providing a "default rule" that applies only in the absence of an agreement altering that rule.

This article focuses on the LLC as authorized under the Act.

Supp. 1991) Nevada Limited Liability Company Act, 1991 Nev. Stat. Ch. 442; Texas Limited Liability Company Act, 1991 Tex. Sess. Law Serv. Ch. 901, § 46.

11. A Maryland State Bar Association committee drafted a limited liability bill that was introduced in the Maryland legislature in its 1991 session. *See* MARYLAND STATE BAR ASSOCIATION SECTIONS OF TAXATION AND BUSINESS LAW, REPORT OF THE SPECIAL JOINT COMMITTEE ON A PROPOSED MARYLAND LIMITED LIABILITY COMPANY ACT (1990) [hereinafter PROPOSED MARYLAND REPORT]. The legislation was carried over to the 1992 session for further study.

A survey of LLC legislation undertaken by the Subcommittee of Limited Liability Companies of the Section of Taxation of the American Bar Association shows that as of August 1, 1991, LLC legislation has been proposed in seven states in addition to the eight states that have passed LLC statutes and Maryland.

12. Telephone interview with Richard C. Hite, Chairman, Scope and Programs Committee, National Conference of Commissioners on Uniform State Laws (June 10, 1991).

13. VA. CODE ANN. §§ 13.1-601 to -781 (Repl. Vol. 1989 & Cum. Supp. 1991).

14. *Id.* §§ 50-73.1 to .77.

15. *Id.* §§ 50-1 to -43.

Part II explores the fundamental provisions of the Act. Part III discusses the LLC in light of the requirements for partnership classification under the Internal Revenue Code ("IRC") and compares an LLC, which is classified as a partnership for income tax purposes, to the S corporation and limited partnership. Part IV addresses the applicability of the securities laws to the LLC. Part V discusses the Act's provisions regarding LLCs formed in other jurisdictions as well as the liability concerns for Virginia LLCs transacting business outside the Commonwealth. Finally, Part VI suggests possible business settings in which the LLC may be preferable to other entities.

II. FUNDAMENTAL PROVISIONS OF THE ACT

The Act borrows heavily from both VSCA and VRULPA. Therefore, most of the Act's provisions, viewed separately, will be familiar to Virginia practitioners. What sets the Virginia LLC apart from a corporation or limited partnership formed under Virginia law is the manner in which these provisions are combined. This distinctiveness is underscored by a vocabulary unique to the LLC.

A. *Formation*

In order to form an LLC, articles of organization must be filed with the Virginia State Corporation Commission ("SCC").[16] The articles of organization of an LLC must include all the following:[17] (1) a permissible name,[18] (2) the address of the LLC's initial regis-

16. VA. CODE ANN. §13.1-1010 (Cum. Supp. 1991).

17. Compared with other LLC statutes, the Act requires relatively little information to be set forth in the articles of organization. For example, the Wyoming, Florida and Kansas Acts require the articles of organization to set forth the purpose of the LLC, the total present and future contributions to be made by members, and any right to continue the LLC's business if the LLC is technically dissolved. *See* WYO. STAT. § 17-15-107(a) (1977); FLA. STAT. § 608.407(1) (Supp. 1991); KAN. STAT. ANN. § 17-7607(a). Instead, the Virginia Act requires written records of (1) the times at or events upon which additional contributions will be required from a member, (2) the right of a member to receive distributions from the LLC, (3) the events, if any, which will cause dissolution of the LLC and (4) various other information relating to the LLC and its business, to be maintained at the LLC's principal office and to be made available for member inspection. VA. CODE ANN. § 13.1-1028 (Cum. Supp. 1991); *see also infra* text accompanying notes 52 and 53 for a discussion of the ability of a Virginia LLC to maintain the confidentiality of its internal operations.

18. A name is permissible for purposes of filing the articles of organization with the SCC if, among other things, it contains the word "limited company" or "L.C.," and is distinguishable on the SCC's records from the name of any domestic or registered foreign LLC or any reserved name for an LLC. *Id.* § 13.1-1012.

tered office[19] and the name of its initial registered agent at that office,[20] (3) the address of its principal office[21] and (4) the period of its duration.[22] The articles of organization may, but are not required to, include any matters permitted to be set forth in an operating agreement.[23]

The existence of an LLC does not begin until a certificate of organization is issued by the SCC.[24] Implicit in the SCC's authority to issue a certificate of organization is the power to review the articles of organization to assure that all conditions precedent to the formation of an LLC have been met.[25] Articles of amendment may be filed at any time to add or to modify a provision required or permitted in the articles of organization or to delete a provision not required in the articles of organization.[26]

An LLC may be formed for any lawful purpose except the provision of professional services or except as otherwise provided by the laws of the Commonwealth.[27] An LLC's purpose may be further

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19. The registered office must be in Virginia. *Id.* § 13.1-1015(A). An LLC's registered office may be the same place as any of its places of business. *Id.* § 13.1-1015(A)(1).

20. Only a professional corporation registered to serve as a registered agent under § 54.1-3902 of the Code of Virginia or an individual can serve as the registered agent of an LLC. *Id.* § 13.1-1015(A)(2). If the registered agent of the LLC is an individual, he or she must be either a member or manager of the LLC or a member of the Virginia State Bar. *Id.* The concepts of member and manager are explained *infra* text accompanying notes 32 and 59, respectively.

21. The principal office of an LLC can be either within or outside of Virginia. *Id.* § 13.1-1011(A)(3). In contrast, an LLC formed under the Florida Act must have a place of business in Florida. FLA. STAT. § 608.407(1)(d).

22. VA. CODE ANN. § 13.1-1011(A)(4) (Cum. Supp. 1991). Although this section requires that a period of duration be stated, it does not place any limits on this period. Furthermore, it is unclear under the Act whether the period of duration may only be expressed in terms of time, or whether in the alternative an LLC may have its duration end upon the happening of a specified event. *Compare id.* § 13.1-1011(A)(4) *with* § 13.1-1046(1). This topic is further discussed *infra* note 131.

23. *Id.* § 13.1-1011(B). The concept of an operating agreement is discussed *infra* text accompanying notes 45-72.

24. *Id.* § 13.1-1004(B). In this respect, the LLC follows VSCA rather than VRULPA. VSCA provides that corporate existence begins when the SCC issues a certificate of incorporation, while VRULPA provides that a limited partnership is formed at the time of filing of its certificate of limited partnership, provided that the certificate substantially complies with applicable requirements. *Compare id.* § 13.1-621 (Repl. Vol. 1989) *with* § 50-73.11(B) (Cum. Supp. 1991).

25. *Id.* § 13.1-1004(B) (Cum. Supp. 1991).

26. *Id.* § 13.1-1014(A).

27. *Id.* § 13.1-1008. The Act is the only LLC statute to expressly exclude professional services from the permitted purposes of an LLC. The Utah Act anticipates that professional services will be rendered through LLCs by stating that its provisions do not "alter any law applicable to the relationship between a person rendering professional services and a person

restricted through use of limiting language in the articles of organization.[28] The Act grants an LLC the same powers in transacting business and conducting its affairs that corporations, partnerships, and other business entities are granted under Virginia law.[29]

The articles of organization must be signed and filed by one or more persons.[30] These persons may, but are not required to, be the owners of the LLC.[31] The owners of an LLC are referred to as its "members."[32] Consistent with characterization as a partnership for income tax purposes,[33] an LLC is required to have at least two members.[34] The Act does not restrict membership in an LLC to individuals: a corporation, partnership, LLC, trust, or other entity may be a LLC member.[35] Allowing business and other entities to be members dovetails with the IRC's partnership classification

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receiving those services, including liability arising out of those professional services" but that "[n]o member, manager, or employee of a limited liability company is personally liable for the acts or omissions of any other member, manager or employee. . . ." UTAH CODE ANN. § 48-2b-111. It is conceivable that the General Assembly may enact a professional LLC statute or a provision similar to Utah's to allow professionals to take advantage of the LLC form under operating restrictions similar to those found in the Virginia professional corporation provisions. *See* VA. CODE ANN. §§ 13.1-542 to -556 (Repl. Vol. 1989 & Cum. Supp. 1991).

Some states prohibit LLCs from engaging in other types of business. Under the Wyoming Act, for example, an LLC cannot engage in the banking or insurance business. WYO. STAT. § 17-15-103. The Kansas Act prohibits an LLC from owning or leasing any agricultural land in that state. KAN. STAT. ANN. § 17-7651.

28. VA. CODE ANN. § 13.1-1008. There is no provision in the Act similar to VSCA's provisions requiring a corporation that will engage in the business of a bank or trust company, insurance company, savings and loan or industrial loan association, railroad or other public service company, or public utility to state that purpose in its articles of incorporation and to refrain from engaging in any other business. *See id.* § 13.1-620. However, because the LLC form is not well-suited to the large equity demands these businesses typically have, it is unlikely that many such businesses will operate as LLCs. *See infra* text accompanying note 260.

29. *Id.* § 13.1-1009.

30. *Id.* § 13.1-1010. For the definition of "person" under the Act, see *infra* note 35.

31. VA. CODE ANN. § 13.1-1010.

32. *Id.* § 13.1-1002.

33. Treas. Reg. § 301.7701-2(a)(2) (as amended in 1983) characterizes a partnership as having "associates;" *see also* Morrissey v. Commissioner, 296 U.S. 344, 356 (1935). Likewise, VUPA defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." VA. CODE ANN. § 50-6 (Repl. Vol. 1989).

34. VA. CODE ANN. § 13.1-1002.

35. *Id.* § 13.1-1002 (Cum. Supp. 1991). This section defines a member as "a person that owns a membership interest in a limited liability company." The section goes on to adopt VSCA's definition of "person," which includes an individual or any business or other entity, or the United States or a state or foreign government. An LLC is included in this definition of person by virtue of a provision in the Act stating that any definition of a person under the Code of Virginia that includes a corporation and partnership shall also be deemed to include an LLC. *Id.* § 13.1-1069.

rules, which do not condition partnership status on the legal form of an entity's owners.[36]

In the context of a newly-formed LLC, membership requires a "contribution" to the LLC.[37] The Act's definition of contribution is broader than that of older LLC statutes, allowing contributions to be in the form not only of cash or property, but also of services or a binding obligation to contribute cash, property or services.[38]

The Act's provisions regarding enforcement of a member's contribution obligations are derived from VRULPA.[39] A promise to make a contribution is not enforceable unless set out in a writing signed by the member.[40] If the promise is enforceable, neither death, disability nor any other reason will relieve the member of the obligation.[41] If a member fails to make a required contribution of property or services, the LLC may require the member to make a cash contribution equal to the value of such property or services.[42] A promise to make a contribution can be compromised by an LLC if all its members consent, unless a provision to the contrary is included in the articles of organization or an operating agreement.[43] However, such a compromise is ineffective with respect to a creditor who has extended credit or otherwise acted in reliance on the contribution obligation.[44]

B. *Management*

1. The Operating Agreement and Management by Managers

An understanding of the management flexibility permitted by the Act requires explanation of another concept unique to the

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36. *See infra* text accompanying notes 142-84.

37. VA. CODE ANN. §§ 13.1-1002, -1027.

38. *Compare* VA. CODE ANN. § 13.1-1002 *with* WYO. STAT. § 17-15-115 and FLA. STAT. § 608.4211 (both providing that a contribution to an LLC may be in "cash or other property, but not services"). Under federal income tax law, the receipt of a partnership interest in exchange for services generally results in taxable income to the service-contributing partner. *See infra* note 204.

39. *See* VA. CODE ANN. § 50-73.33 (Repl. Vol. 1989).

40. *Id.* § 13.1-1027(D) (Cum. Supp. 1991).

41. *Id.* § 13.1-1027(B).

42. *Id.* It is not clear whether this provision would be interpreted to prevent the LLC from bringing suit in equity to specifically enforce a member's promise to contribute real property or other unique property. The cash equivalent value of any property which a member has promised to contribute to the LLC must be kept in a written record at the LLC's principal office. *Id.* § 13.1-1028(A)(5)(a).

43. *Id.* § 13.1-1027(C).

44. *Id.*

LLC: the "operating agreement." An operating agreement is an agreement among the members of an LLC regarding its affairs and the conduct of its business.[45] An LLC is not required to have an operating agreement;[46] in the absence of an operating agreement, an LLC is governed completely by the Act's default rules.

The Act permits any provisions concerning an LLC's affairs and business to be included in an operating agreement to the extent they are not inconsistent with the laws of Virginia or the LLC's articles of organization.[47] Since the Act is part of the laws of Virginia, a provision in an operating agreement attempting to vary a provision of the Act that is mandatory, as opposed to a default rule, should not be enforceable. Likewise, where a conflict exists between an LLC's articles of organization and its operating agreement, the articles of organization govern.

An operating agreement may be oral unless the LLC's articles of organization require a written operating agreement.[48] Furthermore, the Act does not require that the existence of an oral operating agreement be indicated in the articles of organization, any certificate or instrument evidencing a member's interest in the LLC, or in any other manner that would give notice to a non-member.[49]

In recognizing oral operating agreements and not requiring notice of their existence to non-members, the Act aligns itself with VRULPA and VUPA, which permit oral limited partnership agreements and general partnership agreements, respectively.[50] In contrast, section 13.1-671.1 of the Code of Virginia, which permits a corporation with thirty-five or fewer shareholders to establish provisions for the governance of the corporation different from those set forth in VSCA through use of a qualified shareholder agree-

45. VA. CODE ANN. §§ 13.1-1002, -1023(A). The Wyoming, Colorado and Utah Acts also refer to such an agreement as an operating agreement. *See* WYO. STAT. § 17-15-116; COLO. REV. STAT. § 7-80-102(11); UTAH CODE ANN. § 48-2b-126(2). This type of an agreement is referred to in the Florida and Texas Act as "regulations" and in the Kansas Act as "bylaws." *See* FLA. STAT. § 608.423; 1991 Tex. Sess. Law Serv. Ch. 901, § 46, Art. 2.09; KAN STAT. ANN. § 17-7613.

46. VA. CODE ANN. § 13.1-1023(A).

47. *Id.*

48. *Id.* § 13.1-1023(B)(1).

49. However, in the absence of a written operating agreement, certain information that would be proper subject-matter for such an agreement must be maintained in a written record at the LLC's principal office and must be available for a member's reasonable inspection. *See supra* note 17.

50. *See* VA. CODE ANN. §§ 50-73.1 with respect to oral limited partnership agreements. VUPA contains no provision expressly prohibiting an oral general partnership agreement.

ment, requires not only that such an agreement be in writing, but also that a legend be applied to share certificates of the corporation to give notice of the agreement's existence.[51] These differing treatments illustrate the divergence between the statutory dictate and default rule concepts. VSCA, consistent with its strict and detailed regime, imposes a set of conditions on the method for varying from this regime. The Act and the partnership statutes, consistent with their preference for minimal restrictions, place few limitations on the manner in which their rules can be overridden.

As mentioned above, an LLC's articles of organization may contain any provisions that are allowed in an operating agreement.[52] However, while a written operating agreement must be kept on record at the LLC's principal office,[53] there is no requirement that the written operating agreement be publicly recorded. Therefore, businesses interested in maintaining the confidentiality of their management structure will choose to set forth management provisions in an operating agreement rather than the articles of organization.

The unanimous consent of an LLC's members is required to initially adopt an operating agreement.[54] Amendments to an operating agreement also require unanimous consent of the LLC's members, unless the operating agreement provides another method of amendment.[55] Premature termination of an operating agreement probably would constitute an amendment of the agreement.

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51. The agreement may be set forth in the articles of incorporation, bylaws or a separate written agreement. *Id.* § 13.1-671.1(B)(1). If the agreement is set forth in the articles of incorporation or the bylaws, it must be approved by all persons who are shareholders of the corporation at that time. *Id.* § 13.1-671.1(B)(1)(a). If the agreement is in the form of a separate written agreement, it must be signed by all persons who are shareholders of the corporation at the time. *Id.* § 13.1-671.1(B)(1)(b).

Failure to legend a certificate to indicate the existence of the agreement will entitle a purchaser of the shares represented by that certificate without knowledge of the agreement to rescind the purchase. *Id.* § 13.1-671.1(C). However, failure to properly legend a certificate will not affect the validity or enforceability of the agreement. *Id.*

The agreement is valid for 10 years, unless it provides otherwise. *Id.* §13.1-671.1(B)(3). The agreement may only be amended by unanimous agreement of the persons who are shareholders of the corporation at the time of amendment. *Id.* § 13.1-671.1(B)(2). The agreement ceases to be effective when the corporation has more than 35 shareholders. *Id.* § 13.1-671(1)(D).

52. *Id.* § 13.1-1011(B).

53. *Id.* § 13.1-1028(A)(4). A member has the right to inspect and copy a written operating agreement upon reasonable request. *Id.* § 13.1-1028(B)(1).

54. *Id.* § 13.1-1023(B)(1). However, the Act does not prescribe the time or times at which an operating agreement can initially be entered into.

55. *Id.* § 13.1-1023(B)(2).

The Act confirms that an operating agreement may be enforced by injunctive or other equitable relief.[56] The availability of equitable relief to enforce an operating agreement may be a consideration in choosing whether to place a provision in an operating agreement or in another document that may not be entitled to equitable enforcement, such as an employment agreement or a membership interest redemption agreement.[57]

The Act does not require that a written operating agreement designate itself as such. However, a practitioner drafting a written operating agreement will no doubt want to set forth in the agreement that it is the intention of the parties that the agreement constitute an operating agreement within the meaning of the Act. In addition, the Act does not address whether a group of agreements taken together can constitute an operating agreement.[58] Thus, if the intention of the members is for a single document to serve as the operating agreement, that intention should be expressed clearly in the document.

An operating agreement, or, if desired, management provisions in the articles of organization, may be used to customize an LLC's management structure. One way in which an LLC's management structure may be customized is by including provisions in an operating agreement or the articles of organization may delegate man-

56. VA. CODE ANN. § 13.1-1023(C)(1). Equitable relief may in certain circumstances may include dissolution of the LLC. *Id.* §§ 13.1-1023(C)(2), -1047; *see also infra* note 134.

The Act does not expressly state that equitable relief is appropriate for management provisions included in the articles of organization rather than in an operating agreement. A court, however, would almost certainly interpret the Act's provisions regarding enforcement of an operating agreement to apply to like provisions in the articles of organization.

57. The Act does not specify the subject-matter parameters of an operating agreement other than to state that it may contain "any provisions regarding the affairs of a limited liability company and the conduct of its business," and to allude to the ability of an operating agreement to override the default rules contained in various management and finance provisions of the Act. VA. CODE ANN. § 13.1-1023(A), and § 13.1-1022(B) (stating that unless the articles of organization or an operating agreement provide otherwise, management decisions of an LLC shall be voted on by members based on their respective contributions). In contrast, the Proposed Maryland Act lists specific examples of provisions that may be set forth in an operating agreement. These include, in addition to provisions regulating management and finances, provisions establishing (1) the right of members to transfer all or a portion of their membership interest, (2) the circumstances under which a transferee will be admitted as a member to the LLC and (3) the right to have a certificate issued evidencing a membership interest and the procedure for assigning, pledging or transferring an interest represented by a certificate. PROPOSED MARYLAND ACT, *supra* note 11 at 37-38, § 4A-402, Commentary.

58. The signature of all members, however, would be required for each such agreement. VA. CODE ANN. § 13.1-1023(B)(1).

agement authority to one or more "managers." A manager must be a natural person eighteen years of age or older, and must meet any additional requirements specified in an operating agreement or the articles of organization.[59] A manager is not required to be a member of the LLC or a Virginia resident unless an operating agreement or the articles of organization so provide.[60]

If managers are desired, a fixed number of managers or a method for determining the number of managers must be specified in an operating agreement or the articles of organization.[61] Under the Act, managers are required to be elected by the members[62] and, unless otherwise provided in an operating agreement or the articles of organization, the majority vote of the members is required to remove a manager or to fill a vacancy in the office of manager.[63] Since the Act does not prohibit a provision in a separate agreement outside an LLC's operating agreement and articles of organization (an "outside agreement") that controls manager positions by requiring the members to vote to elect specified persons as managers, such a provision may be enforceable. If enforceable, a provision of this type would be analogous to the share voting agreement authorized in the corporate context by VSCA.[64]

The only requirement imposed by the Act with respect to the manner in which authority is delegated to managers is, as mentioned above, that such delegation not be inconsistent with Virginia law or, if the delegating provisions are set forth in an operating agreement, with the articles of organization.[65] The Act therefore gives an LLC's members broad leeway in structuring the LLC's management form. For example, a corporate management form could be chosen by simply providing for two classes of managers, one designated as officers and one designated as directors, and by adopting the relevant provisions of VSCA[66] to govern the duties and authority of these managers.[67] In addition, any custom-

59. *Id.* § 13.1-1024(B).
60. *Id.*
61. *Id.* § 13.1-1024(C).
62. The Act does not specify the vote required to elect a manager. *See also infra* text accompanying notes 75-77.
63. *Id.* §13.1-1024(D)-(E).
64. *See id.* § 13.1-671 (Repl. Vol. 1989).
65. *Id.* § 13.1-1023(A) (Cum. Supp. 1991).
66. *Id.* §§ 13.1-673 to -695 (Repl. Vol. 1989).
67. The Proposed Maryland Act would provide the same flexibility. *See* Proposed Maryland Act, *supra* note 11, at 37 § 4A-402, Commentary. However, both types of managers would be required to be elected by the members. VA. CODE ANN. § 13.1-1024(D).

ized management provisions permissible under VSCA by means of a qualified shareholder agreement should be permissible management provisions for an LLC. Examples of such customized management provisions would include those that (1) delegate authority to one or more specified managers to make distributions to members,[68] (2) divide or place conditions on the voting power of members or managers, (3) establish a method for resolving member or manager voting deadlocks, or (4) require dissolution at the request of one or more specified members.[69]

Regardless of the management form under which a manager serves, the Act requires that a manager discharge his duties in accordance with his good faith business judgment in the best interests of the LLC.[70] This standard of conduct is the same as that of a corporate director under VSCA.[71] The Act also parallels VSCA in allowing managers to meet this standard through good faith reliance on information and opinions provided by other managers, manager committees and employees, as well as attorneys, accountants, and other professionals.[72]

The Act is silent as to the application of the apparent authority doctrine to an LLC that utilizes managers. However, the doctrine should certainly have less force in this situation than it does in the corporate context. The Act's tolerance of virtually any form of management should be construed to put third parties on notice that due inquiry into actual authority is essential in transacting business with an LLC.

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68. The delegated authority is subject to restrictions against unlawful distributions. *See infra* text accompanying notes 102-05.

69. *Cf.* VA. CODE ANN. § 13.1-671(1)(A) (Repl. Vol. 1989).

70. *Id.* § 13.1-1024(G) (Cum. Supp. 1991).

71. *Id.* § 13.1-690 (Repl. Vol. 1989). The Colorado Act is the only other LLC statute to provide a standard of conduct for managers. *See* COLO. REV. STAT. § 7-80-406 (Cum. Supp. 1990). The Colorado Act requires that a manager perform his duties as a manager "in good faith, in a manner he reasonably believes to be in the best interests of the limited liability company, and with such care as an ordinarily prudent person in a like position would use under similar circumstances." *Id.* The Colorado Act requires management by managers rule and consequently has the most elaborate management provisions. *See id* §§ 7-80-401 to -411.

72. *Compare* VA. CODE ANN. § 13.1-1024(G)(2) (Cum. Supp. 1991) *with* § 13.1-690(B) (Repl. Vol. 1989). The Colorado Act has a similar provision. *See* COLO. REV. STAT. § 7-80-406(2) (Cum. Supp. 1990).

2. Management by Members

In the absence of a delegation of management authority to managers, management of an LLC vests in its members.[73] Members of an LLC with this form of management structure are entitled to vote in proportion to their respective contributions to the LLC, as adjusted for withdrawals and additional contributions ("proportional vote"), unless an operating agreement or the articles of organization provide for a different manner of voting by the members.[74] Therefore, an operating agreement can be used to customize the member form of management also may be customized by structuring member voting rights on a basis other than the proportional vote.

The Act leaves several questions unanswered with respect to the default form of management. First, although the Act requires unanimous member approval of certain extraordinary actions of the LLC,[75] it does not specify the percentage of the proportional vote needed to approve ordinary LLC action. In contrast, VUPA's default rule for management of a general partnership, which most nearly resembles the Act's management default rule, provides that in the absence of an agreement among the partners, ordinary matters are determined by a majority of the partners.[76] For certainty's sake, an LLC's operating agreement or articles of organization should include a provision stating the percentage of the proportional vote that will be required to approve matters with respect to which the Act does not mandate unanimous consent.[77]

Second, the Act does not address agency and apparent authority issues when management is vested with the members.[78] The ab-

73. VA. CODE ANN. § 13.1-1022(A) (Cum. Supp. 1991).

74. *Id.* § 13.1-1022(B).

75. For example, unanimous member approval is required for admission of an assignee of a membership interest as a member and continuation of an LLC's business upon withdrawal of a member. *See id.* §§ 13.1-1040(A), 13.1-1046(3). *See infra* text accompanying notes 119-39 for a discussion of the assignment of interest and dissolution provisions of the Act.

76. *Id.* § 50-18(h) (Repl. Vol. 1989). Under the VUPA default rule, then, contributions are ignored and partners are counted for decision-making purposes on a one-partner, one-vote basis. VRULPA does not provide a default rule with respect to voting. *See id.* §§ 50-73.23, -73.31.

77. This provision could require different proportional vote percentages for different types of LLC action. For example, it might require a super-majority proportional vote for transactions over a certain dollar amount and a majority proportional vote otherwise.

78. Likewise, no statutory standard of conduct is established for members acting on behalf of the LLC.

sence of provisions addressing these issues is also a departure from VUPA. VUPA states that every partner is an agent of the general partnership who can bind the partnership with respect to any act apparently carrying on the partnership's business in the usual way, unless the partner lacks authority to so act and the person with whom he is dealing has knowledge of this fact.[79] Conversely, VUPA provides that acts of a partner not apparently carrying on the partnership's business in the usual way do not bind the partnership unless authorized by the other partners.[80] VUPA goes on to list a number of acts that require authorization by all the partners to bind the partnership, presumably because they do not constitute carrying on the partnership's business in the usual way.[81] While these same rules might apply in the context of a member-managed LLC through application of general agency principles,[82] more certainty would be achieved if the Act included provisions similar to those contained in VUPA.[83]

3. Indemnification and Limitation of Liability

The Act contains an indemnification provision and a provision permitting limitation of liability to the LLC applicable to both members and managers.[84] The wording of these provisions, though, raises several questions. With respect to indemnification, the Act confers on an LLC the power to "indemnify a member or manager or any other person to the same extent as a corporation may indemnify any of the directors, officers, employees or agents of the

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79. VA. CODE ANN. § 50-9(1) (Repl. Vol. 1989).

80. *Id.* § 50-9(2).

81. *Id.* § 50-9(3). These acts include (1) assigning partnership property in trust for the benefit of creditors or for an assumption of the partnership's debts, (2) disposing of the goodwill of the partnership's business, (3) doing any act which would make it impossible to carry on the ordinary business of the partnership, (4) confessing a judgment, or (5) submitting a partnership claim or liability to arbitration or reference. *Id.*

82. *See, e.g.*, Hobbs v. Virginia Nat'l Bank, 147 Va. 802, 128 S.E. 46 (1925), *rev'd on rehearing*, 147 Va. 830, 133 S.E. 595 (1926) (analyzing the doctrine of partnership by estoppel under both case law and the VUPA).

83. The Proposed Maryland Act would establish apparent agency rules for members' acts which correspond to the apparent agency rules for partners' acts set forth in VUPA. *See* Proposed Maryland Act, *supra* note 11, at 32, § 4A-401.

84. In addition, in a member derivative action, the Act permits the court to order the plaintiff to pay the defendant's reasonable attorney's fees and other expenses if the court finds that the action was commenced without reasonable cause or the plaintiff did not fairly represent the interests of the members and the LLC in the action. VA. CODE ANN. § 13.1-1045 (Cum. Supp. 1991).

corporation."[85] The indemnification provisions of VSCA, though, not only permit indemnification of corporate agents, they also require such indemnification in certain instances.[86] The indemnification provision of the Act leaves doubt as to whether an LLC is required or merely allowed to provide indemnification to its members, managers and other agents in those situations where VSCA mandates indemnification by a corporation of its agents.[87] If mandatory indemnification is desired in these instances, a suitable provision should be included in an operating agreement or the articles of organization.

With respect to limiting liability to the LLC, the Act provides that, other than for willful misconduct or a knowing violation of the criminal law, the maximum amount a manager or member can be liable for in any proceeding brought by or in the right of an LLC or its members is the greater of $100,000 or the cash compensation received by the manager or member in the preceding twelve months.[88] Furthermore, an operating agreement or the articles of organization can set a lower liability limit or eliminate liability altogether.[89] This provision is sufficiently clear with respect to a manager (which would include a member who serves as a manager) because the manager acts in a single statutory capacity with respect to the LLC. However, a member can act in two capacities under the Act: as an agent of an LLC where no managers serve and as an owner of the LLC. Clearly, the Act's limitation of liability provision will apply to actions of the member in his capacity as an agent of the LLC. It is uncertain, though, whether this limitation is intended to apply to the actions of a member in his ownership capacity. For example, an operating agreement could entitle an LLC to redeem a member's membership interest upon the happening of a specified event. If the member breaches the agreement by refusing to sell back his membership interest when this event occurs,

85. *Id.* § 13.1-1009(16).

86. Unless limited by its articles of incorporation, a corporation is required to indemnify any director, officer, employee, or agent of the corporation who entirely prevails in the defense of any proceeding to which he is a party because he is or was serving in that capacity against reasonable expenses incurred by him in connection with the proceeding. *Id.* §§ 13.1-698 and 702(1) (Repl. Vol. 1989).

87. The Colorado Act, in contrast, expressly provides mandatory indemnification in this situation unless limited by the LLC's articles of organization. *See* COLO. REV. STAT. § 7-80-410(3) (Cum. Supp. 1990). The Colorado's Acts extensive indemnification provision is consistent with its requirement of management by managers. *See supra* note 71.

88. VA. CODE ANN. § 13.1-1025(A)(2)(Cum. Supp. 1991).

89. *Id.* § 13.1-1025(A)(1).

and the operating agreement also eliminates member liability, would the LLC be allowed to recover damages for the breach?[90]

4. Acquisition of an LLC's Business

The Act contains no provisions corresponding to those in VSCA concerning corporate acquisitions: mergers, statutory share exchanges, and sales or other dispositions outside the ordinary course of all or substantially all the assets of a corporation.[91] Likewise, the Act contains no provisions corresponding to the dissenters' rights provisions of VSCA.[92] Since the Act does not include special provisions authorizing mergers or statutory share exchanges, transactions in which an LLC's business is acquired by another LLC or entity can occur in three basic ways: (1) acquisition of the membership interests in the LLC by another entity, (2) distribution of the LLC's assets, along with liabilities secured by those assets if desired, to the members, some or all of whom contribute or sell those assets to another entity,[93] or (3) sale of the LLC's assets, along with its liabilities, if desired. The Act's assignment of interest provisions will protect members from undesired acquisitions of membership interests.[94] However, the Act contains no provisions governing the distribution of all or substantially all of an LLC's

90. A court could require specific performance by the member since the provision is contained in an operating agreement. *See supra* text accompanying notes 56 and 57. It should be noted that the Act also allows a person who is a member or manager to transact business with the LLC in a capacity other than as a member or manager. *Id.* § 13.1-1026. The Act's limitation of liability provisions certainly should not apply to liability arising from this type of transaction, because the person's status as a member or manager is irrelevant in that context.

91. The Kansas, Utah, and Texas Acts contain provisions governing LLC mergers. *See* KAN. STAT. ANN. § 17-7650; UTAH CODE ANN. 48-2b-149 (Cum. Supp. 1991); 1991 Tex. Sess. Law Serv. Ch. 901, § 46, Article 8.12. The Kansas and Utah Acts require that the merger be undertaken by way of an agreement among the merging LLCs specifying the surviving LLC. KAN. STAT. ANN. § 17-7650(a); UTAH CODE ANN § 48-2b-149. If one or more domestic LLCs will not survive the merger, the merger will become effective when articles of dissolution filed with respect to each non-surviving domestic LLC become effective. KAN. STAT. ANN. § 17-7650(d); UTAH CODE ANN. § 48-2b-149(4). Otherwise, the merger apparently is effective at the time or upon the events specified in the agreement. The Texas Act allows an LLC to merge with another LLC or a corporation, general partnership, or limited partnership under the provisions of the Texas Business Corporation Act. 1991 Tex. Sess. Law Serv. Ch. 901, § 46, Article 8.12. The Texas Act is the only LLC statute that addresses statutory membership interest exchanges or sales of all or substantially all of an LLC's assets. *Id.*

92. *See* VA. CODE ANN. §§ 13.1-729 to -741 (Repl. Vol. 1989 & Cum. Supp. 1991).

93. Such a transaction may, but is not required to, be accompanied by a dissolution of the LLC.

94. *See infra* text accompanying notes 119-31.

assets to its members or the sale or other disposition of all or substantially all of an LLC's assets outside of the normal course of business. Therefore, it is possible for an LLC's business to be distributed to members, some of whom contribute the assets received to another LLC or entity, without a member vote.[95] Likewise, it is possible for an LLC's assets to be transferred to another LLC or entity in exchange for cash, interests in the other entity,[96] or other property without a member vote. In order to provide member protection in this situation, an operating agreement or the articles of organization could provide that unanimous or super-majority membership consent is required to approve such transactions. If only super-majority consent were required, dissenting members could be protected by allowing them to redeem their membership interests for a redemption price determined by means of a formula intended to estimate the fair market value of those interests.

C. *Finance*

The principle of flexibility seen throughout the Act's management provisions extends to its finance provisions as well. The Act permits the members of an LLC to customize both the distribution of cash and property and the allocation of profits and losses to its members through an operating agreement or the articles of organization. In the absence of any finance provisions in an operating agreement or the articles of organization, the Act provides that distributions will be made and profits and losses will be allocated on a proportional basis in accordance with the members' respective contributions.[97] This default rule differs from the management default rule in that withdrawals are not deducted from contributions to determine a member's proportional share of distributions and allocations.[98] In the event an LLC's members desire that distributions and allocations be made on the same basis as the proportional

95. This scenario could only occur if the LLC were managed by managers. *See supra* text accompanying notes 59 through 72 for a discussion of management of an LLC by managers. VRULPA recognizes that limited partners may be given voting rights with respect to sales of all or substantially all a limited partnership's assets. VA. CODE ANN. § 50-73.24(B)(6)(b) (Cum. Supp. 1991).

96. If the ownership interests in the other entity received by the LLC were then distributed to the LLC's members, the transaction would be equivalent to a merger in practical effect.

97. *Id.* § 13.1-1029.

98. VRULPA requires contributions to be netted against withdrawals in determining allocation of profits and losses and distribution of income. *See id.* § 50-73.34 to -73.35.

vote, a provision requiring a netting of withdrawals against contributions in determining members' respective shares of distributions and allocations should be included in an operating agreement or the articles of organization.

The Act recognizes that, through an operating agreement or the articles of organization, two or more classes of membership may be established with different rights as to distributions.[99] As with management form, then, an LLC's equity structure may be customized to emulate that of a corporation. For example, "preferred" and "common" classes of membership may be created, with the preferred class granted priority rights with respect to operating or liquidating distributions, or both, over the common. Other equity features associated with the corporate form, such as cumulative distribution rights and conversion rights, do not appear to be prohibited. Alternatively, an LLC's equity structure could imitate that of a complicated partnership, with "flips" of distribution percentages among the members at certain times, upon certain events, or based on the source of the distribution.[100]

An LLC is not prohibited from having a membership class structure for allocation purposes that differs from its membership class structure for distribution purposes. However, such an arrangement may create income tax complications.[101]

An LLC, like a corporation formed under VSCA, is prohibited from making distributions[102] which would render it insolvent or

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99. VA. CODE ANN. § 13.1-1030. This provision is derived from VRULPA. *See id.* § 50-73.35. The Colorado Act has a similar provision. *See* COLO. REV. STAT. § 7-80-504. The Proposed Maryland Act provides that, in the absence of an agreement otherwise, distributions shall be made in proportion to the members' respective right to share in profits in the LLC, while profits and losses allocations shall be allocated in accordance with the member's respective capital interests. PROPOSED MARYLAND ACT, *supra* note 11, at 53, § 4A-505. Neither Wyoming, Florida nor Kansas provide default rules with respect to distributions and allocations.

100. For an example of a provision establishing distribution flips between the general partner and the limited partners based on whether the distribution is from net cash from operations or net cash from sales or refinancing, see 3 R. WHITMIRE, W. NELSON, W. MCKEE & M. KULLER, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS: STRUCTURING AND DRAFTING AGREEMENTS ¶ 7.04[1], Form 7-18 (1989).

101. *See infra* note 201 and accompanying text for a synopsis of the income tax rules regarding special allocations.

102. The Act defines a distribution as a "direct or indirect transfer of money or other property, or incurrence of indebtedness by a limited liability company, to or for the benefit of its members in respect of their interests." VA. CODE ANN. § 13.1-1002 (Cum. Supp. 1991). This definition should include not only distributions of operating proceeds of an LLC, but also redemptions of membership interests. *Compare id. with* § 13.1-603 (Repl. Vol. 1989)

impair its capital. The LLC is not permitted to make a distribution if after such distribution (1) the LLC would not be able to pay its debts as they become due in the ordinary course of business or (2) the LLC's total assets would be exceeded by its total liabilities plus the amount needed to satisfy the dissolution rights of any membership interests which are superior to the dissolution rights of the member receiving the distribution.[103] As in the corporate context, an LLC can base its determination regarding either of these tests on financial statements prepared on the basis of reasonable accounting principles or a fair valuation or other method reasonable under the circumstances.[104] If a member receives a distribution in violation of these restrictions, an operating agreement or the articles of organization, the member is liable to the LLC for the amount wrongly distributed for a period of six years thereafter.[105]

D. *Liability of Members and Managers*

One of the key advantages of the LLC is that it can provide limited liability to all its members and managers. The Act specifically states that unless the articles of organization provide otherwise, an individual or entity does not have any personal obligation for liabilities of an LLC, whether such liabilities arise in contract, tort or otherwise, solely by reason of being a member, manager or other agent of the LLC.[106] The Act procedurally reinforces the protection offered by this default rule by providing that a member is not a proper party to a proceeding by or against an LLC, except when the proceeding is for the purpose of enforcing the member's right against or liability to the LLC or is brought by the member under the derivative action provisions of the Act.[107]

(specifically providing that a redemption or share acquisition is a "distribution" within the meaning of VSCA).

103. *Id.* § 13.1-1035(A) (Cum. Supp. 1991).

104. *Id.* § 13.1-1035(B). Therefore, financial statements prepared in accordance with generally accepted accounting principles consistently applied ("GAAP") are not required. This flexibility is an accommodation to the many small businesses that prepare their financial statements on the cash basis, since GAAP requires that financial statements be on an accrual basis.

105. *Id.* § 13.1-1036.

106. *Id.* § 13.1-1019. However, a member is liable to the LLC for any obligations to contribute cash or property or to perform services that have not been met. *See supra* text accompanying notes 39-44. In addition, a member is liable to the LLC for unlawful distributions made to the member by the LLC. *See supra* text accompanying note 105.

107. VA. CODE ANN. § 13.1-1020. This provision is derived from similar provisions in the

The ability to insulate an LLC member from personal liability in his capacity as a member, regardless of his management activities, is one of the primary distinctions between an LLC and a limited partnership. Under VRULPA, a limited partner who participates in the partnership's management may become personally liable for partnership obligations.[108] The Act follows VSCA in this regard, allowing an LLC member to exercise management power without exposure to personal liability in a manner comparable to a shareholder of a Virginia corporation who also serves as one of its officers or directors.

The above is not meant to imply that a person cannot incur personal liability in connection with an LLC in a capacity other than as a member, manager, or agent of the LLC.[109] For example, a member may be personally liable for obligations of the LLC which he has personally guaranteed.[110] In addition, a member or manager may be personally liable for his own negligence, despite the fact that his negligence arose in the course of performance of his duties to the LLC.[111] Similarly, a member or manager may incur personal liability under the Comprehensive Environmental Response, Compensation and Liability Act[112] or similar environmental laws as an "operator" of a facility despite the fact that the LLC owns the facility.[113]

Wyoming, Florida and Proposed Maryland Acts. *See* WYO. STAT. § 17-15-130; FLA. STAT. § 608.462; PROPOSED MARYLAND ACT, *supra* note 11, at 30 § 4A-302.

108. VA. CODE ANN. § 50-73.24(A) (Cum. Supp. 1991). A limited partner who participates in the partnership's management is liable to persons who transact business with the partnership reasonably believing, based on the limited partner's conduct, that the limited partner is a general partner. *Id.* VRULPA provides a non-exclusive list of activities which a limited partner may undertake without being deemed to participate in the management of the partnership. *Id.* § 50-73.24(B). This list includes, among other things, (1) being a contractor, agent or employee of the partnership or a general partner; (2) consulting with a general partner with respect to partnership business; (3) acting as a surety for or guaranteeing or assuming one or more partnership obligations; and (4) voting on certain matters, including dissolution of the partnership, the sale or disposition of all or substantially all of its assets, the incurrence by the partnership of indebtedness other than in the ordinary course of business, or the admission or removal of a general or limited partner. *Id.*

109. However, unlike VSCA, the Act does not impose personal liability on members or managers who approve an unlawful distribution. *See id.* § 13.1-692 (Repl. Vol. 1989).

110. *Cf.* Wurzburg Bros., Inc. v. Coleman, 404 So. 2d 334 (Ala. 1981) (shareholder-president of corporation who signed note which did not indicate his capacity as president held personally liable as guarantor of note).

111. *Cf.* Harless v. First Nat'l Bank, 169 W. Va. 673, 289 S.E.2d 692 (1982) (corporate employee held personally liable for tort of retaliatory discharge of subordinate).

112. 42 U.S.C. § 9601 to 9657 (1988).

113. *Cf.* New York v. Shore Realty Corp., 759 F.2d 1032, 1052 (2d Cir. 1985) (corporate shareholder held liable as operator of property owned by corporation).

The equitable remedy of "piercing the corporate veil" will no doubt be applicable to LLCs, exposing members to personal liability for failure to maintain the separate identity of the LLC combined with misuse of the LLC form.[114] It has been suggested that because the flexibility of the LLC's management structure allows it to operate without observing the type of formalities imposed on corporations,[115] the LLC may be more susceptible to a veil-piercing argument than a corporation. A court should reject such an argument for two reasons.

First, managers and members should be entitled to rely on compliance with the Act as sufficient observance of formalities. Otherwise, the Act's grant of limited liability will be subject to a judicial gloss of vague conditions, leaving LLC members and managers uncertain of the exact actions that must be taken to assure that the LLC form will be respected.

Second, VSCA itself allows corporations to eliminate the formalities it otherwise imposes, to the extent not contrary to public policy, through use of a qualified shareholder agreement.[116] VSCA expressly provides that the existence or performance of a qualified shareholder agreement

> shall not be a ground for imposing personal liability on any shareholder for the acts or debts of the corporation even if the agreement or its performance treats the corporation as a partnership or results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.[117]

If a corporation can eliminate VSCA's formalities without the implication that such action makes it more prone to corporate veil-piercing, an LLC should be given the same advantage.[118]

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114. *See generally* Epperson & Canny, *The Capital Shareholder's Ultimate Calamity: Pierced Corporate Veils and Shareholder Liability in the District of Columbia, Maryland and Virginia*, 37 CATH. U.L. REV. 605 (1988).

115. Observance of corporate formalities includes (1) sufficient organizational action, namely execution and filing of articles of incorporation, adoption of bylaws and organizational minutes and issuance of stock certificates and (2) adoption of annual minutes, action by board resolution and execution of corporate agreements and instruments by persons acting in their capacities as officers. *Id.* at 641.

116. *See supra* note 51 and accompanying text.

117. VA. CODE ANN. § 13.1-671.1(F) (Cum. Supp. 1991).

118. The Colorado Act clarifies this issue by expressly providing that, in an action to set aside the limited liability of an LLC, the court "shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law." COLO. REV. STAT. § 7-80-107 (Cum. Supp. 1990).

E. *Assignments of Membership Interests*

The provisions of the Act regarding assignment of membership interests are based on the corresponding provisions of VRULPA.[119] Unless an operating agreement or the articles of organization provide otherwise, a membership interest is assignable in whole or in part.[120] Upon the assignment of an entire membership interest, the assignor ceases to be a member of the LLC, unless otherwise provided by an operating agreement of the articles of organization.[121] However, the assignment, whether in whole or in part, of a membership interest entitles the assignee only to receive, to the extent assigned, the distributions from the LLC to which the assignor would otherwise be entitled.[122] In order for the assignee to participate in the management and affairs of the LLC and to exercise other membership rights, the remaining members must unanimously consent to the assignee's admission as a member.[123] The Act does not specifically prohibit a provision in an outside agreement requiring all members to consent to an assignee becoming a member on the direction of certain members or on a percentage of the proportional vote of the membership.[124] Therefore, it is arguable that such a required consent provision is enforceable. However, this type of provision may cause undesirable tax consequences.[125]

An assignee who becomes an LLC member is liable for any contributions which the assignor was obligated to make and any wrongful distributions made to the assignor, to the extent the assignee member has knowledge of these obligations at the time he becomes a member.[126] The Act provides that the assignor remains liable for these obligations as well.[127] Since the Act places no conditions on an LLC's enforcement of these obligations against either

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119. *See* VA. CODE ANN. §§ 50-73.45 to .47 (Repl. Vol. 1989).

120. *Id.* § 13.1-1039 (Cum. Supp. 1991). A membership interest in an LLC is considered personal property. *Id.* § 13.1-1038.

121. *Id.* § 13.1-1039.

122. *Id.*

123. *Id.* § 13.1-1040. VRULPA allows an assignee of a partnership interest to become a limited partner not only on the consent of the remaining partners, but also in any manner described in writing in the partnership agreement. *Id.* § 50-73.47(A) (Repl. Vol. 1989). This later method of gaining admission was not included in the Act because it was thought to jeopardize the LLC's classification as a partnership for tax purposes. *Cf. infra* note 184.

124. A provision imposing this type of obligation on members with respect to a given action is hereinafter sometimes referred to as a "required consent provision."

125. *See supra* note 184 and accompanying text for a discussion of this issue.

126. VA. CODE ANN. § 13.1-1040(B) (Cum. Supp. 1991).

127. *Id.* § 13.1-1040(C).

party, the LLC is free to proceed against the assignee member and the assignor individually (in any order of priority) or jointly. The assignee and the assignor should therefore consider factoring these obligations into the purchase price for the membership interest, and requiring the party to whom the purchase price allocates these obligations to indemnify the other party.

The Act also allows a judgment creditor of a member to obtain a charging order on the member's membership interest.[128] To the extent the membership interest is charged, the creditor is granted the rights to receive distributions from the LLC.[129]

The Act does not address whether an LLC's acceptance of a contribution from a person in return for a membership interest constitutes an assignment requiring the consent of all members in order for the contributor to exercise membership rights.[130] If the members desire to admit contributors as members upon less than unanimous consent, a required consent provision should be included in an outside agreement which obligates all members to consent to the admittance of a contributor if the desired members, number of members, or percentage of the proportional vote of the members consents to the admittance.

F. *Dissolution*

An LLC is dissolved under the Act (1) at the time or upon the events specified in the articles of organization or an operating agreement,[131] (2) upon the unanimous consent of the members,[132] (3) upon the death, resignation, expulsion, bankruptcy, or dissolution of a member or any event that terminates the continued membership of the member in the LLC, unless the business of the LLC is continued by the unanimous consent of the remaining members[133] or (4) upon judicial decree if it is not reasonably practicable

128. *See id.* § 13.1-1041. The Colorado Act has a similar provision. *See* COLO. REV. STAT. § 7-80-703.

129. VA. CODE ANN. §§ 13.1-1041 (Cum. Supp. 1991).

130. Interpreting the acceptance of a contribution as an assignment would, in effect, provide an LLC member with the preemptive right to maintain his percentage ownership interest in the LLC.

131. VA. CODE ANN. § 13.1-1046(1) (Cum. Supp. 1991). This provision can be read to permit an LLC to file articles of organization specifying an event upon which the LLC will be dissolved rather than a fixed date or time period.

132. *Id.* § 13.1-1046(2).

133. *Id.* § 13.1-1046(3). A unanimous consent requirement was chosen to strengthen the case for classifying an LLC formed under the Act as a partnership for tax purposes. The

to carry on the LLC's business in accordance with its articles of organization and any operating agreement.[134]

A required consent provision in an outside agreement assuring continuation of the LLC's business upon an event that terminates the continued membership of a member in the LLC, like a required consent provision in an outside agreement concerning membership interest assignments, is not specifically prohibited by the Act, and, therefore, is arguably enforceable. Yet, also like a required consent provision concerning membership interest assignments, a required consent provision assuring continuation of the LLC's business upon termination of a member's continued membership in the LLC may cause undesirable income tax consequences.[135]

Upon dissolution, an LLC is required to wind up its affairs by distributing its assets.[136] Assets must be distributed (1) first to creditors, including members in their capacities as creditors other than for unpaid distributions, (2) then, unless otherwise provided in an operating agreement or the articles of organization, to members in satisfaction of liabilities for unpaid distributions and (3) finally, unless otherwise provided in an operating agreement or the articles of organization, to members first for the return of their contributions and then in the proportions in which they share in distributions.[137] The statute's distribution requirement, however, does not necessitate satisfaction of an obligation at the time of dissolution if the LLC makes reasonably adequate provision for the

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Florida Act, in contrast, allows the business of the LLC to be continued not only on the unanimous consent of the remaining members, but also pursuant to "a right to continue stated in the articles of organization . . . ." FLA. STAT. § 608.441(1)(c) (Supp. 1991). For a discussion of the tax aspects of this issue, see *infra* note 155.

134. VA. CODE ANN. §§ 13.1-1046(4), -1047 (Cum. Supp. 1991). Judicial dissolution is only available upon application of a member. By analogy to VSCA, judicial dissolution should be available if (1) the managers or managing members of the LLC are deadlocked and such deadlock will cause irreparable injury to the LLC's business; (2) the managers or managing members have acted, are acting or will act in an illegal, fraudulent or oppressive manner; (3) the members have failed to elect successor managers for a period of two annual meetings due to deadlock or (4) the corporate assets are being misapplied or wasted. *Cf. id.* § 13.1-747(A)(1) (Repl. Vol. 1989).

135. *See infra* text accompanying notes 156-59.

136. VA. CODE ANN. §§ 13.1-1046, -1049 (Cum. Supp. 1991).

137. *Id.* § 13.1-1049. In providing that, for purposes of the distribution of an LLC's assets on dissolution, the claim of a member for an unpaid distribution is junior to the claims of other creditors, this section appears to conflict with § 13.1-1035(D) of the Code which states that the declaration of a lawful distribution is at parity with the LLC's liability to its general creditors, except where subordinated by agreement. *See id.* § 13.1-1035(D).

satisfaction of the obligation at the time of dissolution.[138] Upon complete distribution of the LLC's assets, a certificate of cancellation is filed with the SCC.[139]

III. Tax Considerations

A. *Partnership Classification*

Revenue Ruling 88-76 rekindled interest in LLCs by classifying an LLC organized under the Wyoming Act as a partnership for federal income tax purposes.[140] As stated above, the Act was drafted so that an LLC formed pursuant to its provisions would also receive partnership classification under federal income tax law.[141]

While the terms "partnership" and "corporation" are used throughout the IRC, the IRC's definition of these terms is too broad to achieve consistency in application.[142] The test for deter-

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138. *Id.* § 13.1-1050(A). The Act contains no provision similar to that in VSCA allowing a corporation to bar certain fixed claims that are not confirmed by creditors. *See id.* § 13.1-746(A) (Repl. Vol. 1989).

139. *Id.* § 13.1-1050(A) (Cum. Supp. 1991). The certificate of cancellation must set forth (1) the name of the LLC, (2) the date of filing the articles of organization and each amendment thereto, (3) the reason for filing the certificate and (4) the effective date of the certificate, if it is not to be effective on filing. *Id.*

140. Revenue Ruling 88-76 analyzed a Wyoming LLC which had 25 members, three of whom were designated its managers. Rev. Rul. 88-76, 1988-2 C.B. 360. In addition, the IRS has issued two private letter rulings classifying LLCs formed under the Florida Act as partnerships. *See* Priv. Ltr. Ruls. 90-10-027 (Dec. 7, 1989) and 89-37-010 (June 16, 1989) both issued pursuant to Rev. Proc. 89-12, 1989-1 C.B. 798.

141. The IRS has begun a project to consider issuing a revenue ruling on the tax classification of the Virginia LLC. In the meantime, the IRS will accept requests for private letter rulings with respect to the tax classification of LLC's formed under the Act pursuant to Revenue Procedure 89-12. Revenue Procedure 89-12 is for use by both "those [organizations] formed as partnerships and other organizations seeking partnership classification." Rev. Proc. 89-12 § 1.02, 1989-1 C.B. 198. It provides that if the entity seeking an advanced ruling is not organized under a state limited partnership act, its references to "general partner" shall be deemed to mean those members with significant management power relative to the other members. By implication, those other members will be deemed to be "limited partners" for purposes of Revenue Procedure 89-12.

It is anticipated that the Virginia income tax classification of an LLC will follow the federal classification. In contrast, distributions made by an LLC to its members are taxable as corporate dividends under Florida income tax law. Fla. Stat. § 608.426.

142. The IRC defines a partnership to include "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation." I.R.C. § 7701(a)(2) (1991); *accord* I.R.C. § 761(a). A corporation is defined to include "associations, joint-stock companies, and insurance companies." I.R.C. § 7701(a)(3) (1991).

mining whether an unincorporated business entity is classified for federal income tax purposes as a partnership or an association taxable as a corporation is provided by Treasury Regulations section 301.7701-2,[143] commonly referred to as the "*Kintner* regulations."[144] The *Kintner* regulations disregard an entity's status under local law, instead basing classification on four principal characteristics of pure corporations.[145] These characteristics are: (1) continuity of life, (2) centralization of management, (3) limited liability and (4) free transferability of interests.[146] Under the *Kint-*

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143. Treas. Reg. § 301.7701-2 (as amended in 1983). These regulations also provide the test for classifying an entity as a trust. *See id.* § 301.7701-2(a)(2). Under the *Kintner* regulations, an entity is considered a trust if it lacks "an objective to carry on business and divide the gains therefrom." *Id.* The Virginia Act provides that an LLC has the purpose of "engaging in any lawful business . . . unless a more limited purpose is set forth in the articles of organization." VA. CODE ANN. § 13.1-1008. This language implies that any LLC formed under the Act has a business purpose. If so, an LLC could not be classified as a trust under the *Kintner* regulations.

144. The *Kintner* regulations were issued in response to United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), in which the court classified a professional organization as an association taxable as a corporation under federal income tax law. The Service had argued for partnership classification, which would have resulted in the organization being ineligible to have a qualified profit-sharing or pension plan. *Id.* at 421, 428. The drafters of the *Kintner* regulations sought to prevent what they perceived as an abuse of corporate status by biasing the regulations in favor of classification as a partnership. *See* August & Shaw, *The Limited Liability Company — A New Tax Refuge?*, 7 J. TAX'N INVEST. 179, 181 (1990).

145. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983).

146. These characteristics are based on the test set forth in Morrissey v. Commissioner, 296 U.S. 344, 356 (1935). Although an entity's status under local law does not dictate its ultimate classification under the *Kintner* regulations, local law is relied upon to determine whether a particular characteristic exists. Treas. Reg. § 301.7701-1(c) (as amended in 1977).

The *Kintner* regulations also state that, in addition to the four corporate characteristics, other factors may exist which are significant to classification of an entity as a taxable association. *Id.* § 301.7701-2(a)(1). However, based on the classification of certain other factors as irrelevant in Larson v. Commissioner, 66 T.C. 159, 184 (1976), *acq.*, 1979-1 C.B. 1, the Service issued Revenue Ruling 79-106. Rev. Rul. 79-106, 1979-1 C.B. 448. This ruling lists a number of factors that will not be treated as additional significant factors in determining the classification of a limited partnership. These factors include, but are not limited to: (1) the division of limited partnership interests into units or shares and the marketing of limited partnership interests in a manner similar to corporate securities, (2) the managing partner's right or lack of right to retain or distribute profits according to the needs of the business, and (3) the limited partner's right or lack of right to vote on the removal and election of general partners or to vote on the sale of all or substantially all of the assets of the partnership. *Id.*

While not falling into the category of "other factors," the lack of "separate interests," resulting from ownership of the entity by affiliated parties, has on at least two occasions prompted the Service to take the position that the entity possessed the characteristics of continuity of life and free transferability of interests. The IRS took this position despite provisions to the contrary under applicable agreements and local law, based on the theory that the affiliated owners would not act independently of one another with respect to these matters. *See* MCA Inc. v. United States, 502 F. Supp. 838 (C.D. Cal. 1980), *rev'd*, 685 F.2d *ner* regulations, if an entity possesses three or more corporate characteristics, it is classified as an association taxable as a corporation; otherwise, it is classified as a partnership.[147]

1. Continuity of Life

An entity lacks continuity of life if the death, retirement, insanity, bankruptcy, or expulsion of any member (referred to herein as an "event of withdrawal") causes the entity to dissolve.[148] As used in the *Kintner* regulations, "dissolution" does not necessarily mean the cessation of the entity's business.[149] Instead, it means "an alteration of the identity of an [entity] by reason of a change in the relationship between its members as determined under local law."[150] An event of withdrawal in a general partnership, such as the resignation of a partner, causes a dissolution because it "destroys the mutual agency which exists between such partner and his copartners and thereby alters the personal relation between the partners which constitutes the identity of the partnership itself."[151] In the limited partnership context, an event of withdrawal of a limited or general partner does not necessarily cause a dissolution of the partnership.[152] The *Kintner* regulations therefore carve out a special rule for limited partnerships by providing that a limited partnership will lack continuity of life if it has "contingent continuity." Contingent continuity, with respect to a limited partnership, exists if an event of withdrawal of a general partner in a limited partnership will trigger dissolution of the partnership, unless

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1099 (9th Cir. 1982); Rev. Rul. 77-214, 1977-1 C.B. 408. If the IRS were to be successful in applying the separate interests doctrine in the context of an LLC, considerable uncertainty would be injected into the analysis of the partnership classification of an LLC with affiliated members. However, a private letter ruling holding that a German partnership lacked continuity of life despite the fact that its partners were two subsidiaries wholly-owned by the same parent raises questions about the continued applicability of the "lack of separate interests" doctrine. Priv. Ltr. Rul. 82-43-193 (July 29, 1982); *see also* 1 W. McKee, W. Nelson & R. Whitmire Federal Taxation of Partnerships and Partners ¶ 3.06[5][b], n.330 (2d ed. 1990).

147. *See* Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983).

148. *Id.* § 301.7701-2(b)(1); *accord Larson*, 66 T.C. at 175 (confirming that continuity of life does not exist if the occurrence of any one of these events to any member triggers a dissolution).

149. *See* Treas. Reg. § 301.7701-2(b)(2) (as amended in 1983).

150. *Id.*

151. *Id.* The *Kintner* regulations expressly provide that a general partnership formed under a statute corresponding to the Uniform Partnership Act ("UPA") lacks continuity of life. *Id.* § 301.7702-2(b)(3).

152. *See, e.g.*, Va. Code Ann. § 50-73.4(3) (Repl. Vol. 1989).

the remaining general partners or all the remaining partners consent to the continuation of the partnership's business.[153]

Revenue Ruling 88-76 determined that a Wyoming LLC had a contingent continuity and therefore lacked continuity of life. Contingent continuity was found because the Wyoming Act's provision requires a LLC to be dissolved under state law upon the occurrence of an event of withdrawal by any member, the LLC's business is continued upon the unanimous consent of the remaining members.[154] In Virginia, the Act's dissolution provisions differ from those of the Wyoming Act only in minor phraseology.[155] Looking only to the Act's dissolution provisions, then, a Virginia

153. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1983). The *Kintner* regulations expressly provide that a limited partnership formed under a Uniform Limited Partnership Act ("ULPA") statute lacks continuity of life. *Id.* § 301.7701-2(b)(3). Furthermore, Treas. Reg. § 301.7701-2(a)(5) (as amended in 1983) provides that all references to ULPA also will be deemed to refer to the Revised Uniform Limited Partnership Act ("RULPA") as adopted in 1976. A new version of the RULPA was adopted in 1985. This special rule for limited partnerships is based on Glensder Textile Co. v. Commissioner, 46 B.T.A. 176, 185 (1942), *acq.*, 1942-2 C.B. 8, which held that a limited partnership lacked continuity of life analogous to a corporation because the retirement, death, or insanity of a general partner would dissolve the partnership unless the remaining general partners consented to continuing it. *See* W. McKee, W. Nelson & R. Whitmire, *supra* note 146, at ¶ 3.06[4][a].

154. Rev. Rule 88-76, 1988-2 C.B. 360, 361. The unanimous consent requirement is based on the special rule under the *Kintner* regulations for analyzing continuity of life in the limited partnership context. As mentioned above, the special rule provides that a limited partnership will lack continuity of life if an event of withdrawal of a general partner causes a dissolution unless all the remaining general partners or remaining partners consent to the continuation of the partnership's business. *See supra* note 153. However, the *Larson* court determined that a limited partnership which allowed the limited partners to replace the general partner by the consent of 51% of the limited partnership interests did not possess continuity of life because each partnership would be technically dissolved upon the bankruptcy of its general partner and the right to continue each partnership was contingent on a vote of the limited partners. *Larson*, 66 T.C. at 168, 175. Similarly, Rev. Rul. 88-79, 1988-2 C.B. 361, 363, determined that a business trust lacked continuity of life despite the fact that the trust would not terminate upon a manager ceasing to be a member if all remaining managers, but merely a majority of participants, consented to the trust's continuation. The Wyoming Act did not provide a *Larson*-like provision for continuing an LLC's business in an attempt to guarantee that the Wyoming LLC would lack continuity of life.

155. *See supra* text accompanying notes 131 through 134. The Virginia Act, like the Wyoming Act, attempts to guarantee the lack of continuity of life, rather than adopting a less restrictive requirement for continuing the LLC's business. *See supra* note 154. As noted above, the Florida Act allows an LLC's business to be continued upon dissolution if either its members unanimously consent, or pursuant to a right set forth in its articles of organization. *See supra* note 133. In Private Letter Ruling 90-10-027 (Dec. 7, 1989), the IRS found that a Florida LLC possessed continuity of life because the LLC's business could be continued upon the consent of merely a majority of its members. This ruling demonstrates that a Florida LLC can be formed which, perhaps unwittingly, possesses continuity of life. *See also* Seemann, *The Florida Limited Liability Company: An Update*, 14 Nova L. Rev. 901, 910-11 (1990).

LLC should lack continuity of life.

A required consent provision in an outside agreement obligating a member to approve the continuation of the LLC's business in all or specified events or on the direction of a member or percentage of members would cast doubt on this conclusion. The *Kintner* regulations provide that an agreement to continue an entity's business upon an event of withdrawal will not trigger a finding of continuity of life unless the effect of the agreement is to deprive a member of the power — as opposed to the contractual right — to dissolve the entity.[156] The courts have held that an agreement which provides simply a remedy at law for breach of an obligation to continue the entity's business does not deprive a member of this power.[157] Under such an agreement, the member retains the power to dissolve the entity; the agreement simply creates liability if he exercises this power and damages result.[158] An outside agreement, however, may be specifically enforceable. If so, the ability to specifically enforce the provision may be interpreted as eliminating a member's power to dissolve the entity upon an event of withdrawal, thereby causing the entity to possess continuity of life.[159] If an outside agreement containing such a provision is used, the agreement should make clear that the remedy for breach of the provision is limited to damages.

2. Centralized Management

An entity possesses centralization of management if a person, or group of persons which does not include all the members of the entity, is vested with exclusive authority to make business decisions for the entity.[160] A general partnership formed under a statute corresponding to UPA lacks centralized management under the *Kintner* regulations because each partner is an agent of the partnership with authority to act on its behalf in the ordinary course of its business.[161] The *Kintner* regulations, assuming that only general partners exercise management authority in a limited partner-

156. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1983).

157. *See, e.g.*, Zuckman v. United States, 524 F.2d 729, 736-37 (Ct. Cl. 1975); Foster v. Comm'r, 80 T.C. 34, 187-88 (1983), *aff'd in part and vacated in part on other grounds*, 756 F.2d 1430 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986).

158. *See* Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?*, 41 U. FLA. L. REV. 721, 729, n.48 (1989).

159. *Cf.* W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 146, at ¶ 3.06[4][a], n.245.

160. Treas. Reg. § 301.7701-2(c)(1) (as amended in 1983).

161. Treas. Reg. § 301.7701-2(c)(4).

ship, provide that a limited partnership, organized in a ULPA or RULPA state, lacks centralized management unless the limited partners own "substantially all the interests in the partnership."[162] While the phrase "substantially all" is not defined in the *Kintner* regulations, it is generally accepted that if the limited partners in a limited partnership own in aggregate 80% or less of the total partnership interests, they will not be considered to own substantially all of those interests.[163]

A modified test of this sort should be applied in the LLC context. Under such a test, if members of an LLC without significant management authority owned substantially all the membership interests, centralized management would exist.[164]

However, in Revenue Ruling 88-76, the IRS did not look to the membership interests of the managers in the LLC. Rather, the IRS determined that the LLC possessed centralized management merely on the basis that it was run by managers.[165] Based on Revenue Ruling 88-76, if an LLC formed under the Act uses managers, or possibly if no managers are used but the members' voting rights are significantly disproportionate to their net contributions, centralized management probably will exist.

3. Limited Liability

An entity possesses the characteristic of limited liability under the *Kintner* regulations if no member is personally liable under local law for the debts of or claims against the entity.[166] A general

162. *Id.*

163. Revenue Procedure 89-12 states that the Service will not issue an advanced ruling that a limited partnership lacks centralized management if the limited partnership interests, other than those held by the general partners, exceed 80% of the total partnership interests. Rev. Proc. 89-12 § 4.06, 1989-1 C.B. 798, 801. While this 80% test is a procedural rather than a substantive requirement, "it is highly unlikely that the Service would assert that a limited partnership possesses centralized management if the general partners own more than 20% of the partnership." W. McKee, W. Nelson & R. Whitmire, *supra* note 146, at ¶ 3.06[4][b].

164. As noted above, Revenue Procedure 89-12 implies that in the context of an entity not organized under a formal limited partnership act, those members without significant management power relative to other members will be deemed to be limited partners for purposes of an advanced ruling that the entity lacks centralized management. *Supra* note 141.

165. Rev. Rul. 88-76, 1988-2 C.B. 360, 361. Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1980) also found that a Florida LLC with management vested in its members in proportion to their capital contributions lacked centralized management.

166. Treas. Reg. § 301.7701-2(d)(1) (as amended in 1983).

partnership formed under a UPA statute lacks limited liability in all circumstances.[167] A limited partnership organized under ULPA or RULPA also lacks limited liability if one of its general partners is considered to have personal liability.[168] A general partner of a limited partnership is deemed personally liable unless he: (1) has no other substantial assets besides his partnership interest that the partnership's creditors can reach, and (2) is merely acting as a "dummy" of the limited partners.[169]

The Wyoming Act provides that neither the members nor the managers of an LLC are personally liable for a debt, obligation or liability of the LLC,[170] although a member is liable to the LLC for promised but unmade contributions and for wrongful distributions.[171] Revenue Ruling 88-76 wasted little analysis in determining that the Wyoming LLC possessed limited liability.[172] Since the Act's default rule regarding member liability is substantially similar to the provisions in the Wyoming Act regarding member liability,[173] a Virginia LLC that does not expressly provide for personal liability on the part of members in the articles of organization should also possess the characteristic of limited liability.

4. Free Transferability of Interests

Finally, an entity possesses free transferability of interests under the *Kintner* regulations if each of its members (or each of those members owning substantially all the entity's interests) is entitled to confer all attributes of his interest on a non-member, without the consent of other members.[174] General partnerships formed

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167. *Id.*

168. *Id.*

169. *Id.* § 301.7701-2(d)(2). The "dummy" requirement is derived from *Glensder*, which characterized a dummy as a person without real means acting as an agent of the limited partners. Glensder Textile Co. v. Commissioner, 46 B.T.A. 176, 186 (1942), *acq.*, 1942-2 C.B. 8. In *Larson*, the court confirmed that under the *Kintner* regulations both a lack of substantial assets and dummy status must be present for limited liability to exist. The court thus rejected the Service's position that the presence of either characteristic would support a finding of limited liability. Larson v. Commissioner, 66 T.C. 159, 180 (1976), *acq.*, 1979-1 C.B. 1.

170. WYO. STAT. § 17-15-113 (Cum. Supp. 1991).

171. *Id.* § 17-15-121.

172. Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

173. *See supra* text accompanying notes 106 and 107.

174. Treas. Reg. § 301.7701-2(e) (as amended in 1983). The significance of this characteristic was demonstrated in 1987 when Congress enacted I.R.C. § 7704, which classifies partnerships whose interests are tradeable on an established or secondary securities market as corporations for federal income tax purposes.

under statutes corresponding to the UPA have been held to lack free transferability of interests because, even though a partner can transfer his interests in the profits of the partnership without the consent of the remaining partners, he cannot transfer any other rights as a partner without such consent.[175] A limited partnership will not have free transferability of interests if the partnership agreement requires the consent of the general partner or partners for the assignee of a limited partnership interest to be admitted as a substituted limited partner, thereby allowing the assignee to exercise voting rights of the limited partnership interest.[176]

A membership interest in an LLC organized under the Wyoming Act is freely assignable.[177] However, the assignee is not entitled to participate in the management of the LLC or to otherwise become a member, except with the consent of the remaining members.[178] Because an assignee's exercise of management and other membership rights is conditioned on the approval of the members other than the assignor, Revenue Ruling 88-76 determined that the Wyoming LLC lacked free transferability of interests.[179]

Although differently worded, the provisions of the Virginia Act regarding assignment of membership interests are substantially the same as those in the Wyoming Act. Unless otherwise provided in the articles of organization or an operating agreement, a member is entitled to freely assign his membership interest.[180] However, this assignment only entitles the assignee to distributions on the membership interest.[181] In order for the assignee to exercise the rights of a member,[182] the remaining members must unanimously consent

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175. *See, e.g.*, Foster v. Commissioner, 80 T.C. 34 (1983), *aff'd in part and vacated in part on other grounds*, 756 F.2d 1430 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986). Under the UPA, a partner has, in addition to distribution rights, the right to act as an agent of the partnership in the ordinary course of its business, to participate in the management of its business, to inspect its records, to demand informational disclosure concerning its affairs from another partner, and in some circumstances to a formal account. *See* UNIF. PARTNERSHIP ACT §§ 9, 18(e), 19, 20, 22; 6 U.C.A. 132, 213, 254, 256, 284 (1969).

176. *See* Treas. Reg. § 301.7701-3(b)(2) (1967), Example 1. However, the *Larson* court held that limited partnership interests were freely transferrable because the general partner was not permitted to unreasonably withhold consent to the admission of an assignee of a limited partnership interest as a limited partner. *Larson*, 66 T.C. at 183.

177. WYO. STAT. § 17-15-122.

178. *Id.*

179. Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

180. VA. CODE ANN. § 13.1-1039 (Cum. Supp. 1991).

181. *Id.*

182. The rights of a member include not only the right to vote, either in management decisions if the LLC is governed by members or in the election of managers if the LLC is

to his admission as a member[183] Therefore, based solely on the Act's assignment provisions, a Virginia LLC should not possess the characteristic of free transferability of interests. However, under the same analysis presented with respect to continuity of life, a required consent provision in an outside agreement obligating members to consent to the admission of assignees may lead to the conclusion that an LLC possesses free transferability of interests.[184]

Therefore, based on Revenue Ruling 88-76, a Virginia LLC should lack at least two of the corporate characteristics set forth in the *Kintner* regulations — continuity of life and free transferability of interests — in the absence of required consent provisions in an outside agreement assuring member consent to both the continuation of the LLC's business upon an event of withdrawal and the admission of assignees of membership interests as members. In addition, an LLC should lack centralized management if it is managed by its members and each member receives a vote in proportion to his net contributions. In either case, a Virginia LLC would not possess three or more corporate characteristics, and thus would be classified as a partnership for federal income tax purposes.

B. *Comparison to S Corporation and Limited Partnership*

In its attempt to combine limited liability with pass-through income tax treatment, the Virginia LLC invites comparison with two familiar entities, the S corporation[185] and the limited partnership.[186] Although an LLC which is classified as a partnership, like the S corporation and the limited partnership, will be a pass-through entity, this moniker camouflages several advantages the

governed by managers, but also (1) to inspect the LLC's records, (2) to vote on the admission of additional members, (3) to vote on a voluntary dissolution or the continuation of the LLC's business upon the event of withdrawal of a member and (4) to bring derivative actions on behalf of the LLC. VA. CODE ANN. §§ 13.1-1022, -1024(D), -1028(B), -1040, -1046, -1042 (Cum. Supp. 1991).

183. *Id.* § 13.1-1040.

184. *Cf. Zuckman*, 524 F.2d at 742 (stating in dicta that a provision in a limited partnership agreement granting a general partner the right to assign his interest and substitute another for himself without the consent of the limited partners causes the general partner's interest to be freely transferrable).

185. An S corporation is a domestically-formed corporation that qualifies and makes an election to be taxed under Subchapter S of the IRC. I.R.C. § 1361 (1991).

186. The following discussion assumes that a limited partnership will be classified as a partnership for federal income tax purposes. *See* Rev. Proc. 89-12, 1989-1 C.B. 798, for the conditions that must be met for an advanced ruling on partnership classification.

LLC enjoys over these other two entities.

1. LLC Compared to S Corporation

In the S corporation context, the IRC exacts a price for pass-through treatment: a corporation must comply with a host of restrictions in order to be eligible for S corporation status. An S corporation cannot have shareholders other than individuals (who cannot be non-resident aliens), estates and certain qualified trusts.[187] An S corporation cannot have more than 35 shareholders.[188] An S corporation cannot have more than one class of stock.[189] An S corporation cannot be a member of an affiliated group[190] or otherwise be an "ineligible corporation."[191] An S corpo-

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187. I.R.C. § 1361(b)(1) (1991). The types of trusts permitted to be S corporation shareholders are: (1) a non-foreign trust treated as owned entirely by a single grantor or beneficiary under I.R.C. §§ 671-78 who is a U.S. citizen or resident individual, (2) a trust described in item (1) after the deemed owner dies, for two years from the date of death of the deemed owner if the entire corpus of the trust is includable in his gross estate, and otherwise for 60 days from his death, (3) a trust to which S corporation stock has been transferred under a will, for 60 days from the transfer, (4) a trust created primarily to exercise voting power of the stock transferred to it and (5) a trust that qualifies and makes an election to be treated as a qualified Subchapter S trust ("QSST"). *Id.* §§ 1361(c)(2), 1361(d).

In order to be a QSST, a trust must distribute all of its income currently to a single individual who is a U.S. citizen or resident and must meet certain other requirements. *See Id.* § 1361(d)(3).

188. *Id.* § 1361(b)(1)(A). For purposes of this requirement, a husband and wife (and their estates) are treated as one shareholder. *Id.* § 1361(c)(1).

189. *Id.* § 1361(b)(1)(D). Differences in the voting rights are ignored for purposes of this requirement. *Id.* § 1361(c)(4). S corporation debt will come within a "straight debt" safe harbor and thus will not constitute a second class of stock if (1) the interest rate thereon is not contingent on profits, the corporation's discretion, or similar factors, (2) the debt is not convertible directly or indirectly into the corporation's stock and (3) the creditor is a qualified S corporation shareholder. *Id.* § 1361(c)(5).

Proposed regulations issued by the Treasury Department would impose the additional requirement that such debt bear a reasonable interest rate in order not to come within the straight debt safe harbor. Prop. Treas. Reg. § 1.1361-1(l)(4)(B), 55 Fed. Reg. 40870 (1990). The proposed regulations also address whether calls, options, warrants or similar instruments constitute a second class of stock for S corporation purposes. Prop. Treas. Reg. § 1.1361-1(l)(3)(iii)(A), 55 Fed. Reg. 40870 (1990). Under the proposed regulations, this type of instrument would be deemed to be a second class of stock if it has a strike price substantially below the market price of the instrument on the date it is issued, or is otherwise substantially certain to be exercised. *Id.* If the strike price of a call option is at least 90% of the fair market value of the underlying stock, the strike price is not considered to be substantially below the market price. *Id.* § 1.1361-1(l)(3)(iii)(C). In addition, a safe-harbor is carved out for a call option issued to an employee in connection with the performance of his services if, within the meaning of Treas. Reg. § 1.83-3(d), the option is nontransferable and does not have a readily ascertainable fair market value at the time of issuance. *Id.* § 1.1361-1(l)(3)(iii)(B).

190. I.R.C. §§ 1361(b)(2), 1504(a) (1991). The effect is to prevent an S corporation from

ration must comply with all these restrictions continuously during its existence; failure to do so will result in immediate termination of S corporation status.[192] If the termination goes unrecognized, significant corporate tax liability may accrue.[193]

No such restrictions are imposed on an LLC classified as a partnership.[194] Although certain requirements will prevent an LLC from being a viable entity for businesses with over thirty-five owners,[195] an LLC classified as a partnership will allow businesses that cannot meet the remaining S corporation restrictions to enjoy S corporation-like benefits. The greatest impact of this ability to bypass S corporation restrictions will probably be in the area of ownership arrangements. An LLC classified as a partnership will permit business entities, including corporations, general and limited partnerships, and other LLCs, all forms of trusts, and foreign individual investors not residing in the United States, to participate in an enterprise which shields all owners from personal liability but is entitled to pass-through income tax treatment. Furthermore, an LLC classified as a partnership will combine limited liability and

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owning 80% or more of the stock of another corporation. The 80% test is not met unless the stock owned possesses at least 80% of the total voting power and 80% of the total value of the corporation's stock. *Id.* § 1504(a)(2). In addition, the 80% test does not apply to the ownership of the stock of another corporation for any period during which that corporation has not begun active business and does not have gross income. *Id.* § 1361(c)(6).

191. *Id.* § 1361(b)(2)(B) to (E). The other types of ineligible corporations are certain types of financial institutions and insurance companies, companies electing the possessions tax credit under I.R.C. § 936, and present and former domestic international sales corporations. *Id.*

192. *Id.* § 1362(d)(4)(A). Termination of S corporation status also occurs: (1) upon a voluntary revocation by the holders of a majority of the corporation's stock as of the date of revocation or (2) in the event the corporation has earnings and profits for any taxable year in which an S corporation election was not in effect and passive investment income in excess of 25% for three consecutive S corporation years. *Id.* §§ 1362(d)(1)(B), 1362(d)(3).

After S corporation status has been terminated, it cannot be reelected until the taxable year after the completion of four taxable years after the taxable year of termination, unless the Service consents. *Id.* § 1362(g).

193. However, a termination which the Service determines to be inadvertent will be deemed not to have occurred if: (1) steps are taken within a reasonable time after the discovery of the terminating event to again qualify for S corporation status and (2) the shareholders agree to make such adjustments as may be required by the Service with respect to the terminated period. *Id.* § 1362(f).

194. Partnership classification of an LLC rests solely on whether an entity has more corporate than non-corporate characteristics under the *Kintner* regulations. *See supra* text accompanying notes 142-84.

195. An enterprise that desires to attract a large number of investors will need to provide those investors with (1) the ability to freely transfer full ownership rights and (2) the certainty that its business will not terminate upon an event of withdrawal of a member. Neither is possible in the LLC. *See supra* text accompanying notes 122, 123 and 133.

pass-through treatment while accommodating any equity arrangement, including corporate equity features such as operating or liquidating distribution preferences, cumulative preferences and conversion rights.

An LLC which is classified as a partnership will also have tax advantages over an S corporation with respect to distributions and allocations. First, the method of computing the basis of a partner in his partnership interest, sometimes referred to as a partner's "outside basis," is preferable to the method of computing an S corporation shareholder's basis in his shares. A partner's outside basis includes his allocable share of all partnership liabilities,[196] while an S corporation shareholder's basis does not include any of the S corporation's liabilities.[197] The at-risk rules will prevent individuals, trusts, estates, and certain closely held C corporations from using this extra basis as a means of deducting losses, except with respect to qualified non-recourse real estate financing.[198] However, cash and property may be distributed as tax-free returns of capital to a partner up to the amount of this additional basis, while to an S corporation shareholder the same distributions will be taxable capital gains since they will exceed his basis in his shares.[199]

Second, unlike an S corporation, an LLC classified as a partnership will allow some flexibility in allocating tax items among its owners. An S corporation's items of income, gain, loss, deduction

196. I.R.C. § 752(a) (1991); *see infra* notes 207-12 and accompanying text for a discussion of the method for determining a partner's allocable share of partnership liabilities.

197. I.R.C. §§ 1371(a)(1), 358(a) (1991). However, an S corporation shareholder is permitted to deduct losses of the S corporation up to the sum of the basis in his S corporation stock plus the basis in any loans he has made to the S corporation. *Id.* § 1366(d)(1)(B). A shareholder's guarantee of S corporation debt is not treated as a loan to the corporation for these purposes. *See, e.g.*, Levitt v. Comm'r, 875 F.2d 420 (4th Cir.), *cert. denied*, 110 S. Ct. 376 (1989) (decided under former Subchapter S).

198. I.R.C. §§ 465(a)(1), 465(b)(6) (1991). The qualified real estate financing exception applies only if (1) the taxpayer borrows money with respect to the activity of holding real property, (2) the loan is made or guaranteed by a federal, state or local government or government instrumentality or is made by a person who is in the active business of lending money and meets other requirements, (3) no one is personally liable for repayment of the loan and (4) the loan is not convertible debt. *Id.* § 465(b)(6)(B).

Even if the real estate financing exception applies, losses passed through to a partner that is an individual, trust, estate, a pass-through entity owned by individuals, trusts or estates, personal service companies and certain closely held C corporations may be characterized as passive under I.R.C. § 469, preventing the current deduction of such losses except to the extent the partner has passive income. *See id.* § 469. For a detailed discussion of the application of the at-risk and passive activity rules to LLCs, see Jordan & Kloepfer, *The Limited Liability Company: Beyond Classification*, 69 TAXES 203 (1991).

199. I.R.C. §§ 731(a)(1), 1368(b)(1), 1368(b)(2) (1991).

and credit must be allocated to its shareholders on a pro rata basis in accordance with their share ownership percentages during the taxable year of the corporation.[200] However, a partnership is allowed to make special allocations of any of these items to a particular partner or partners, provided that the allocations have "substantial economic effect."[201]

Finally, a partnership provides more desirable tax consequences than an S corporation with respect to contributions and distributions of appreciated property.[202] In order for contribution of property to an S corporation to be a nontaxable transaction, the contributing shareholders must be in "control" of the corporation immediately after the contribution.[203] In contrast, there is no control requirement that must be met to make a partner's contribu-

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200. *Id.* §§ 1366(a), 1377(a).

201. *Id.* § 704(b)(2); Treas. Reg. § 1.704-1(b)(2) (as amended in 1988). A detailed explanation of the substantial economic effect test is beyond the scope of this article, but generally speaking, it requires that partnership capital accounts be maintained in a particular manner, that deficit capital accounts be restored upon liquidation of a partner's interest, that liquidating distributions be in an amount equal to the liquidated partner's capital account, and that the allocation not merely provide an after-tax benefit to one partner while leaving the other partners' after-tax positions unchanged. Treas. Reg. § 1.704-1(b)(2) (as amended in 1988). Special allocations allow the partners to distribute tax items among themselves as they wish, provided that economic consequences result.

202. Under federal income tax law, a contribution of services in exchange for an interest in the capital of a partnership, unlike a contribution of property, is a taxable transaction. Treas. Reg. § 1.721-1(b)(1) (1956). The partner contributing services is treated as receiving ordinary income equal to the fair market value of the interest in the year the interest becomes transferable or is no longer subject to a substantial risk of forfeiture. I.R.C. § 83(a) (1991); Treas. Reg. § 1.83-3(b) (as amended in 1985). The partnership, in turn, is entitled in that year to either deduct the fair market value of the interest or to capitalize its value, depending on the nature of the partner's services. Treas. Reg. §§ 1.721-1(b)(2)(i) (1960), 1.707-1(c) (as amended in 1983). A partner who receives such a restricted partnership interest in exchange for services is permitted to make an election to be taxed on the income at the time of receipt. *See* I.R.C. § 83(b). This election should be considered if the interest has minimal value at the time of receipt, but is expected to appreciate substantially by the time the restriction lapses. The receipt of a profits interest in a partnership in exchange for past services has been held to be a taxable event. Diamond v. Commissioner, 492 F.2d 286, 291 (7th Cir. 1974); Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 249 (1990). However, there is substantial authority supporting the proposition that a receipt of profits for the future performance of services does not result in taxable income to the partner. *See* Kobor v. United States, 88-2 U.S.T.C. (CCH) ¶ 9477 (D.C. Cal. 1987); Gen. Couns. Mem. 36,346 (July 23, 1975).

The issuance of S corporation stock in exchange for services is also a taxable transaction and subject to the I.R.C. § 83 recognition rules. *See* I.R.C. §§ 1371(a)(1), 351(d)(1) (1991).

203. "Control" means the direct ownership of stock possessing at least 80% of the combined voting power of all classes of voting stock and at least 80% of the total number of shares of all classes of non-voting stock. I.R.C. § 368(c) (1991); Rev. Rul. 59-259 1959-2 C.B. 115.

tion of appreciated property to the partnership a nontaxable transaction.[204]

With respect to distributions of appreciated property, an S corporation recognizes taxable income as if it had sold such property to the receiving shareholder for the fair market value of the property at the time of distribution.[205] A distribution of the property by a partnership to one of its partners, however, does not result in taxable income to the partnership.[206]

If classified as a partnership, then, an LLC will have significant advantages over an S corporation with respect to ownership structure, allocations of tax items and tax treatment of contributions and distributions of appreciated property.

2. LLC Compared to Limited Partnership

Because it can provide limited liability to all its owners, an LLC which is classified as a partnership will in many instances be able to offer more desirable allocations for outside basis purposes than a limited partnership. The temporary regulations addressing the inclusion of liabilities in a partner's outside basis[207] provide that "recourse" liability of the partnership, which for purposes of the section 752 regulations means liability for which one or more of the partners bears the economic risk of loss,[208] is included in the outside bases of only those partners so obligated, in proportion to their respective obligations to discharge the liability.[209]

In contrast, "nonrecourse" liability, which for purposes of the section 752 regulations means liability as to which no partner bears

204. I.R.C. § 721 (1991).

205. *Id.* § 1371(a), 311(b)(1). I.R.C. § 311(b)(1) statutorily repealed the *General Utilities* doctrine, named for General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935), where the IRS argued unsuccessfully that a distribution of appreciated property to a shareholder should result in a taxable gain to the distributing corporation.

206. I.R.C. § 731(b) (1991). The only exception to this rule is where a distribution in exchange for all or part of a partner's partnership interest results in the alteration of the partners' respective interests in unrealized receivables and substantially appreciated inventory of the partnership. *See id.* § 751; Treas. Reg. § 1.751-1 (as amended in 1971).

207. The temporary regulation is referred to herein as the "section 752 regulations." Temp. Treas. Reg. §1.752-1T (as amended in 1989).

208. *Id.* § 1.752-1T(d)(1). A partner bears the economic risk of loss for a liability to the extent that the partner would bear the economic burden of discharging the liability if the partnership were unable to do so. *Id.* § 1.752-1T(a)(1)(iii).

209. *Id.* § 1.752-1T(b).

the economic risk of loss,[210] is included in the outside bases of all partners in proportion to their profits interests in the partnership.[211] In a limited partnership, therefore, all liabilities except those (1) for which the limited partners bear the economic risk of loss through a guarantee or other arrangement or their status as creditors with respect to the liability and (2) those that for state law purposes are with recourse only to partnership property are allocated entirely to the general partners, since they alone are personally obligated for all such partnership liabilities. Unless a substantial amount of a limited partnership's liabilities have been guaranteed or otherwise become ultimate obligations of the limited partners or are with recourse only to partnership property securing those obligations, partnership liabilities will have little upward impact on the outside bases of the limited partners.

In the typical LLC, however, all members have limited liability. All LLC liabilities, except those that are personally guaranteed by one or more members or with respect to which one or more members are the creditors are allocated to all the members' outside bases in accordance with their profits interests.[212] Therefore, the LLC more effectively facilitates the sharing among all owners of outside bases arising from liabilities than does the limited partnership. To the extent members can avoid personal guarantees, or other obligations for LLC liabilities, the effect will be to prevent a situation in which some members have very low outside bases, severely limiting their ability to receive tax-free distributions of cash or property, while other members will have outside bases in substantial excess of the tax-free distributions they anticipate to receive over the life of the LLC.

In addition, an LLC member may be able to achieve material participation in the LLC, such that the income and losses passed through to the member are considered active income and losses under the IRC's passive loss rules, without risking personal liability. In contrast, a limited partner who materially participates in the partnership's business within the meaning of the passive loss rules may risk liability as a general partner for the partnership's

210. *Id.* § 1.752-1T(e)(2).
211. *Id.* § 1.752-1T(e)(3)(ii).
212. *Id.* § 1.752-1T(d)(3)(ii)(B)(4)(ii)(B) (stating that the liabilities of an entity which is treated as a partnership for federal income tax purposes, but which provides all members with limited liability, will constitute nonrecourse liabilities for purposes of the § 752 regulations).

obligations.[213]

IV. SECURITIES LAW CONSIDERATIONS

A membership interest in an LLC, like a general or limited partnership interest, will constitute a security subject to the Securities Act of 1933[214] ("Securities Act") if it is determined to be an "investment contract" within the meaning of the Securities Act.[215]

SEC v. W.J. Howey Co.[216] provides the general definition of an investment contract. Under *Howey*, an investment contract exists if a person invests money or other legal consideration in a common enterprise with the expectation of profits derived solely from the efforts of others.[217] The vast majority of LLCs, like their partner-

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213. For a detailed discussion of the impact of the passive loss rules on the LLC, see Jordan & Kloepfer, *supra* note 198; For a list of the activities in which a limited partner may engage without being deemed a general partner, see *supra* note 108.

214. 15 U.S.C. § 77a to 77bbbb (1988 & Supp. I 1990).

215. The term "investment contract" is included in the definition of "security" in the Securities Act. 15 U.S.C § 77b(1). The term has been held to bring within the scope of the Securities Act "those schemes which involve in substance, if not form, securities." SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973), *cert. den.* 414 U.S. 821 (1973). Because general and limited partnership interests are not specifically listed within the Securities Act's definition of security, investment contract analysis is used to determine whether a particular general or limited partnership interest constitutes a security. *See, e.g.*, Rivanna Trawlers Unlimited v. Thompson Trawlers, 840 F.2d 236, 240-41 (4th Cir. 1988) (applying investment contract analysis to a general partnership interest); Rodeo v. Gillman, 787 F.2d 1175, 1177-78 (7th Cir. 1986) (applying investment contract analysis to a limited partnership interest); SEC v. Murphy, 626 F.2d 633, 640 (9th Cir. 1980) (applying investment contract analysis to a limited partnership interest). Likewise, investment contract analysis will be applied to determine whether a membership interest in an LLC constitutes a security within the meaning of the Securities Act. However, no cases or Securities and Exchange Commission no-action letters have been found addressing the security status of an LLC membership interest.

It is conceivable that a membership interest which closely resembles a corporate equity interest could be deemed "stock" within the meaning of 15 U.S.C. § 77b(1) and thus constitute a security. *Cf.* Cole v. Ford Motor Co., Fed. Secs. L. Rep. (CCH) ¶ 99,403 [1983-84 Transfer Binder] (W.D. Pa. 1983) (instrument issued to automobile dealer by automobile manufacturer in connection with manufacturer's financing of dealer's business held to be stock but not an investment contract under the Exchange Act of 1934).

216. 328 U.S. 293 (1946).

217. *Id.* The definition of "security" under the Virginia Securities Act, VA. CODE ANN. § 13.1-501 to -527.3 (Repl. Vol. 1989 & Cum. Supp. 1991), includes the term "investment contract" and is otherwise almost identical to the Securities Act's definition. *Compare* VA. CODE ANN. § 13.1-501 (Cum. Supp. 1991) *with* 15 U.S.C. § 77b(1) (1988). The SCC has stated that investment contract analysis may be applied to an LLC membership interest and that whether such an interest constitutes a security should be determined on a case-by-case basis. Letter from Robert G. Lewis, Deputy Director, Division of Securities and Retail Franchising of the SCC (May 17, 1991). California and a number of other states, however, apply a "risk capital" test which is more likely to classify a transaction as involving a secur-

ship counterparts, will meet the investment,[218] common enterprise[219] and expectation of profits elements of the definition.[220] Therefore, whether a particular LLC membership interest is a security under federal securities law usually will turn on whether profits are derived solely from the efforts of others.[221]

The cases applying the *Howey* test have not given a literal reading to the term "solely."[222] Instead, they consider this element met if others provide "those essential managerial efforts which affect the failure or success of the enterprise."[223] Generally speaking, under the *Howey* test as interpreted by the courts, a limited partnership interest is presumed to be a security,[224] while a general partnership interest (whether in a general or limited partnership) is presumed not to be a security.[225]

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ity than the *Howey* test. *See generally* Campbell, *The Federal Definition of a Security - An Examination of the "Investment Contract" Concept and the Propriety of a Risk Capital Analysis under Federal Law*, 12 TEX. TECH L. REV. 911, 922 (1981).

218. Periodic capital calls to limited partners made at the discretion of the general partner have been held to constitute offerings of separate securities to the limited partners under the *Howey* test. *See* Goodman v. Epstein, 582 F.2d 388, 414 (7th Cir. 1978), *cert. denied* 440 U.S. 939 (1979); *accord*, Interpretive Release on Regulation D, Securities Act Release No. 33-6455, Fed. Secs. L. Rep. (CCH) ¶ 2,380 (Mar. 3, 1983), Question 34 (discretionary capital calls in an oil and gas limited partnership are not included in the initial offering price for the limited partnership interests for Regulation D purposes; instead they are separate offerings, although subject to integration with the initial offering).

219. The circuits are split as to the type of common enterprise test to apply. Some circuits apply a horizontal commonality test, which requires the joint participation of more than one investor in the investment of funds or the sharing of profits. Other circuits recognize a vertical commonality test as an alternative to the horizontal commonality test.

The circuits that recognize the vertical commonality test are themselves split: some apply a broad interpretation, which is satisfied merely if the success or failure of an investment is primarily dependent on the expertise or efforts of a promoter, while others use a narrow interpretation which requires that there be some mutuality of financial interest between the investor and the promoter with respect to the investment.

A partnership or LLC should always meet the horizontal commonality test unless it only has one investor in addition to its promoter. A one investor - one promoter partnership or LLC will meet the broad interpretation of the vertical commonality test and, based on the circumstances, may meet the narrow interpretation. For a detailed discussion of this issue, see Note, *Defining an "Investment Contract:" The Commonality Requirement of the Howey Test*, 43 WASH. & LEE L. REV. 1057 (1986).

220. Several courts have held that an expectation of profits can exist even where the investors are primarily motivated to invest because of favorable tax benefits. *See, e.g., Goodman*, 582 F.2d at 407; Stowell v. Finkell Inv. Servs., 489 F. Supp. 1209, 1221 (S.D. Fla.), *aff'd*, 641 F.2d 323 (5th Cir. 1980).

221. *See, e.g., Rivanna Trawlers*, 840 F.2d at 240 (where the court, without discussion, assumed the first three parts of the *Howey* test to exist).

222. *See id.* at 240, n.4, and cases cited therein.

223. *Glenn W. Turner Enters.*, 474 F.2d at 482.

224. *See, e.g., Murphy*, 626 F.2d at 640; *Goodman*, 582 F.2d at 406.

225. *See, e.g., Rivanna Trawlers*, 840 F.2d at 240; Fund of Funds v. Arthur Andersen &

These presumptions, however, can be overcome. With respect to a limited partnership interest, if the limited partner is given veto power over the general partner or partners on a wide range of matters, the profits of the partnership will not be considered to be derived solely from the efforts of persons other than the limited partner.[226] Conversely, a general partnership interest will be considered a security if the general partner is so dependent on a manager or management group (which could include other general partners) that the general partner is unable to replace the manager or management group or otherwise exercise ultimate control.[227] This situation will exist if the partnership agreement or other agreements leave such little power in the hands of the general partner that the interest resembles a limited partnership interest.[228]

The same presumptions will almost certainly be applied in the LLC context. If the LLC is managed by managers, a presumption will be created that the membership interest of a member who does not serve as a manager constitutes a security. Otherwise, the presumption will be that none of the membership interests are securities. While these presumptions will be rebuttable based on the specific management form of the LLC under review,[229] they serve as good rules of thumb in assessing the applicability of the Securities Act to different LLC management structures.

Co., 545 F. Supp. 1314, 1348 (S.D.N.Y. 1982); Kline v. Aircoa Equity Interests, Fed. Secs. L. Rep. (CCH) ¶ 94,855 [1989-90 Transfer Binder] (D. Colo. 1989).

226. *See, e.g.*, Bamco 18 v. Reeves, 675 F. Supp. 826, 830 (S.D.N.Y. 1987); Bank of Am. Nat'l Trust & Savs. Ass'n v. Hotel Rittenhouse Assocs., 595 F. Supp. 800, 806-07 (E.D. Pa. 1984).

227. *Rivanna Trawlers*, 840 F.2d at 241; Williamson v. Tucker, 645 F.2d 404, 423 (5th Cir.) (dicta), *cert. denied*, 454 U.S. 897 (1981).

228. *Rivanna Trawlers*, 840 F.2d at 241, n.7; Matek v. Murat, Fed. Secs. L. Rep. (CCH) ¶ 94,108 [1988-89 Transfer Binder] (9th Cir. 1988). *But see Williamson*, 645 F.2d at 423 (stating that the inability to exercise ultimate control can also exist if a general partner is so inexperienced that he is effectively unable to exercise his partnership power, or if a manager has a unique expertise vital to the partnership's business).

229. For example, if no managers are used but the LLC's management structure gives certain members substantially disproportionate voting power in comparison to other members, the other members' membership interests may be considered securities. An LLC could initially have a management structure which results in membership interests not constituting securities and later modify its management form such that some or all of its membership interests become securities. Such a conversion should be deemed a sale of securities under Securities Exchange Commission Rule 145, 17 C.F.R. § 230.145 (1991). *See* Campbell, *Rule 145: Mergers, Acquisitions and Recapitalization Under the Securities Act of 1933*, 56 FORDHAM L. REV. 277, 288-90 (1987) (stating that a change in the issuer's form of entity should always constitute a sale of securities under federal law if it involves a material alteration in the rights of entity owners).

V. Multistate Transactions

A. *Foreign LLCs Transacting Business in Virginia*

In addition to establishing a statutory framework for the Virginia LLC, the Act recognizes and regulates LLCs organized in other states or jurisdictions that transact business in the Commonwealth. The Virginia Act provides that an LLC organized under the laws of another state or jurisdiction will be governed by those laws with respect to "its formation and internal affairs and the liability of its members and managers,"[230] with two limitations.

First, the Act's recognition of foreign law is subject to any limitations imposed by the Virginia Constitution.[231] No LLC statute presently in effect, including the Colorado statute which requires an LLC to be managed by members, appears to offend the Virginia Constitution. However, if a foreign LLC were considered a "foreign corporation" within the meaning of article IX, section 5 of the Constitution of Virginia, that provision would prohibit the foreign LLC from engaging in the business of a public service enterprise in the Commonwealth.[232]

Second, a foreign LLC is not permitted to exercise rights and privileges greater than those enjoyed by a Virginia LLC. Therefore, a foreign LLC is not permitted to engage in the rendering of professional services in the Commonwealth.[233]

The Virginia Act does not demarcate the exact parameters of a foreign LLC's "internal affairs." However, by analogy to the corporate internal affairs doctrine, the matters governed by a foreign LLC's jurisdiction of organization should include (1) procedural matters such as the original organization of the LLC, the election or appointment of its managers, the adoption of its operating agreement, the holding of member and manager meetings, the methods of voting (including cumulative voting) and the right to inspect the LLC's records, (2) the declaration or payment of distributions and redemptions of outstanding membership interests, (3) the status of persons as members, (4) the management participation, liquidation and voting rights of a member, (5) the enforceability of voting trusts, (6) the fiduciary duties of a member hold-

230. Va. Code Ann. § 13.1-1051 (Cum. Supp 1991).
231. *Id.*
232. Va. Const. art. IX, § 5.
233. *See supra* note 27 and accompanying text.

ing a majority interest in the LLC to minority members, (7) the existence and extent of a member's liability to the LLC, and (8) the existence and extent of a manager's liability to the LLC, its members and creditors.[234]

A foreign LLC transacting business in Virginia is required to register with the SCC.[235] Registration is accomplished by a person with authority to act on behalf of the LLC under the laws of the jurisdiction of its organization filing an application on a form prescribed by the SCC.[236] The application must set forth, among other things, the state or other jurisdiction of the LLC's formation, the date of formation, the registered office and agent of the LLC in Virginia, and a copy of the LLC's articles of organization.[237]

The penalty for an unregistered LLC transacting business in Virginia is that suit may not be brought in a Virginia court, although the LLC is permitted to defend a suit brought against it in such a forum.[238] In addition, after a hearing for which the individual has received notice, a fine of between $500 and $5,000 may be imposed on each member, manager, or employee of an unregistered foreign LLC who does business in Virginia and knows that registration is required and has not been obtained.[239] The transactions that do not constitute doing business in Virginia under the Act for purposes of registration of a foreign LLC are virtually identical to those that do not constitute doing business in Virginia for purposes of a foreign corporation registering under VSCA.[240]

B. *Virginia LLCs Transacting Business Outside the Commonwealth*

VSCA does not expressly require that Virginia courts defer to the law of the jurisdiction under which a foreign corporation is incorporated with respect to matters of shareholder liability.[241] An

234. *Cf.* Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 15 n.46 (listing matters which are governed by a corporation's jurisdiction of incorporation under the corporate internal affairs doctrine as set forth in the RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 302-307, 309 (1971)).

235. VA. CODE ANN. § 13.1-1052 (Cum. Supp. 1991).

236. *Id.*

237. *Id.*

238. *Id.* § 13.1-1057(A),(B).

239. *Id.* § 13.1-1057(C).

240. *Compare id.* § 13.1-1059 *with id.* § 13.1-757(B).

241. However, VSCA does state that its provisions do not authorize the Commonwealth to regulate the organization or internal affairs of a foreign corporation authorized to trans-

express provision is unnecessary, given that courts have firmly established that the law of the jurisdiction of incorporation will govern such matters.[242] In contrast, the Act's recognition of the law of the jurisdiction of organization of a foreign LLC as governing the liability of its members is a response to uncertainties concerning the liability treatment of LLCs transacting business outside the jurisdiction of their organization.

Currently, only two states' legislatures other than Virginia's have expressly directed their courts to apply the laws of the jurisdiction of an LLC's organization as to matters of member liability.[243] The courts of seven other states would probably reach this same result, although not statutorily obligated to do so.[244] The courts of the remaining states have expressed no position as to which state's law should govern with respect to the liability of an LLC member.

A case frequently cited for its refusal to apply the law of the jurisdiction of an entity's organization with respect to owner liability is *Means v. Limpia Royalties*.[245] In *Means*, suit was brought in Texas to rescind the purchase of an interest in a business trust[246] organized in Oklahoma.[247] The investor had purchased the interest on the representation of the promoters of the trust that he would not be subject to personal liability for the trust's obligations.[248]

act business in Virginia. *Id.* § 13.1-761(C) (Repl. Vol. 1989).

242. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 307 and reporter's notes (1971).

243. Those states are Colorado and Kansas. *See* COLO. REV. STAT. § 7-80-901; KAN. STAT. ANN. § 17-7636(a).

244. Those states are Utah, Texas, Nevada, Wyoming, Florida, Indiana and Maryland. The Utah Act provides for the registration of foreign LLCs, but states that its provisions do not "govern the organization and internal affairs of a foreign limited liability company." UTAH CODE ANN. § 48-2b-143(1), -144. The Texas and Nevada Acts have a similar provision. 1991 Tex. Sess. Law Serv. Ch. 901, § 46, Article 7.01; 1991 Nev. Stat. Ch. 442, *to be codified at* NEV. REV. STAT. § 551. The Wyoming and Florida Acts do not recognize foreign LLCs at all. It seems unlikely, though, that the courts of those states would not respect the law of organization of a foreign LLC as to member liability, since they grant limited liability to members of domestic LLCs. *See* FLA. STAT. § 608.435, -436; WYO. STAT. § 17-15-113, -121.

Although Indiana has not adopted an LLC statute, an LLC may register to transact business in Indiana as a foreign LLC. IND. CODE ANN. §23-16-10-1 to -10.1-1 (Burns 1989 & Supp. 1990). An LLC may register to transact business in Maryland as a foreign corporation. Memorandum from Kaye Brooks Bushel, Assistant Attorney General, State of Maryland to Dean W. Kitchen (Jan. 24, 1990). In either state, the ability to register would probably be construed as approval of the law of the jurisdiction in which a foreign LLC is organized as to member liability.

245. 115 S.W.2d 468 (Tex. Civ. App. 1938).

246. *See supra* note 3 for a brief discussion of the history of the business trust.

247. *Means*, 115 S.W.2d at 469.

248. *Id.* at 474-75.

Oklahoma law did provide limited liability to shareholders of such a trust; however, Texas law treated such shareholders as general partners for liability purposes.[249] The Texas court ruled that principles of comity could not displace Texas' established public policy with respect to the liability of shareholders in a business trust.[250] Accordingly, the court allowed recision of the purchase on the basis that the promoters made material misrepresentations concerning the limited liability of shareholders in the trust.[251]

In *Farmers' & Merchants' National Bank v. Anderson*,[252] a Texas bank brought suit in Iowa against several shareholders of a business trust organized in Texas when the trust defaulted on a note held by the bank.[253] Iowa law provided limited liability to the shareholders in such a trust unless they mutually agreed to share its liabilities.[254] Because the shareholders had not made such an agreement, the court dismissed the suit holding that Iowa public policy overrode principles of comity in this instance.[255] Therefore, applying the same reasoning as the *Means* court, the *Anderson* court reached the opposite result with respect to trust shareholder liability.

These two cases illustrate the inconsistent treatment that LLCs will experience if courts of other jurisdictions allow notions of local public policy to influence their decisions with respect to LLC member liability. Such inconsistent decisions can only invite forum-shopping. The need for coherence with respect to fundamental issues such as member liability presents a compelling reason for following the law of the state in which an LLC is organized with respect to the liability of its members.[256] Abiding by the law of an LLC's jurisdiction of organization will allow the LLC to be a viable

249. *Id.*
250. *Id.* at 475.
251. *Id.*
252. 216 Iowa 988, 250 N.W. 214 (1933).
253. *Anderson*, at 989-91, 250 N.W. at 216.
254. *Id.* at 995, 250 N.W. at 217.
255. *Id.* at 999, 250 N.W. at 219-20.
256. The application of the law of the jurisdiction of organization to the internal affairs of an entity has constitutional underpinnings in the Full Faith and Credit Clause and the Commerce Clause. *See* Kozyris, *supra* note 234, at 30-46. The enforcement of the law of a corporation's state of incorporation with respect to matters of shareholder liability will insure uniform treatment of the corporation's shareholders as well as yield to the law of the state most likely to have the dominant interest in the determination of the issue. RESTATEMENT (SECOND) OF CONFLICTS OF LAWS, § 307 comment a (1971). Similarly, it has been argued that for practical reasons the liability of owners of a business trust must be determined under the laws of a single state, that of the trust's formation. Note, *supra* note 3, at 1145-46.

choice of entity in today's increasingly national and international business markets.

Because no cases have addressed the issue of member liability in multistate transactions, no assurances can be given that an LLC's members will be insulated from personal liability in jurisdictions that have not adopted LLC statutes. However, as stated above, a committee has been formed to study the advisability of a uniform LLC statute.[257] Such a statute would clear the way for nationwide recognition of the LLC's limited liability. Until that time, Virginia practitioners representing LLCs will want to make members well aware of the risks associated with conducting business in other jurisdictions.

Certain steps can be taken to mitigate the possibility of personal liability being imposed on LLC members.[258] If an LLC will be transacting business in a jurisdiction that does not provide for registration of foreign LLCs, an attempt should be made to register the LLC as a foreign corporation.[259] In addition, the articles of organization should not list as a specific purpose of an LLC that it will transact business in a jurisdiction which does not recognize the limited liability of LLCs, since such a provision could be interpreted to be a consent to be governed by that jurisdiction's laws.

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257. *See supra* note 12 and accompanying text.

258. Colorado has attempted to statutorily mitigate the possibility of personal liability being imposed on members of Colorado LLCs. COLO. REV. STAT. § 7-80-106. This statute provides:

> It is the intention of the general assembly by the enactment of [the Colorado Act] that the legal existence of limited liability companies formed under [the Colorado Act] be recognized beyond the limits of this state and that, subject to any reasonable registration requirements, any such limited liability company transacting business outside this state be granted the protection of full faith and credit under section 1 of article IV of the Constitution of the United States.

Id.

259. The West Virginia Secretary of State has refused to allow a Florida LLC to register as a foreign corporation. Telephone interview with Robert E. Wilkinson, Deputy Secretary of State of West Virginia (May 21, 1991). The California Secretary of State did not permit a Wyoming LLC to register as either a foreign corporation or limited partnership. Letter from Bill Holden, Staff Counsel, Corporate Division, California Secretary of State, to Michael L. Kreuger (Sept. 20, 1990). Even if permitted, registration as a foreign limited partnership would be undesirable because at least one LLC member would need to be designated as the "general partner" of the LLC, exposing that person to potential personal liability in the state of registration.

VI. Use of the LLC in Selected Situations

Though it provides flexibility in both management and financial structure, there are limits to the situations in which the LLC will be used. Because of the restrictions on transfer of membership rights and continuation of the LLC's business upon an event of withdrawal of a member, the LLC will not be a publicly-traded entity.[260]

Even for some smaller businesses, such as service providers, the LLC may not be the most desirable entity. For example, a personal service corporation may be able to consistently eliminate any taxable income through payment of reasonable salaries and bonuses. Since such an entity will not generate taxable income, a C corporation may be desired in order that shareholder employees may be provided certain tax-favored employee fringe benefits not available on a tax-favored basis to partner/employees of a partnership and more than two percent shareholder/employees of an S corporation.[261] It also should be remembered that the LLC will not be available to a sole proprietor who seeks limited liability, since an LLC must have at least two members.[262] In this situation, an S corporation may be the appropriate entity.

However, assuming that tax classification and choice-of-law issues are resolved favorably, the LLC could become the entity of choice in a variety of situations. The following examples are provided as a point of departure in illustrating the benefits available

260. *See supra* notes 122, 123, 133 and accompanying text. Even if an LLC could achieve partnership classification without these restrictions, certain publicly-traded LLCs would be subject to taxation as corporations under the publicly-traded partnership provisions of the tax code. I.R.C. § 7704 (1988).

261. Unlike a C corporation employee, a partner in a partnership, or an employee who owns over two percent of an S corporation, is taxed on the value of the following employee fringe benefits: (1) the $5,000 death benefit exclusion under I.R.C. § 101(b), (2) the exclusion from income of amounts paid for an accident and health plan under I.R.C. § 105(b)-(d), (3) the exclusion from income of amounts paid by an employer to an accident and health care plan under I.R.C. § 106, (4) the exclusion of the cost of up to $50,000 of group-term life insurance on an employee's life under I.R.C. § 79, and (5) the exclusion from income of meals or lodging furnished for the convenience of the employer under I.R.C. § 119. S. Rep. No. 640, 97th Cong., 2d Sess. *reprinted in* 1982 U.S. Code Cong. & Admin. News 3253, 3272-73 (1982). The preceding provisions extend tax-favored treatment to common law employees but not to self-employed individuals, such as partners, as defined under tax code § 401(c)(1). *See* I.R.C. §§ 101(b)(3), 105(g) (1991), 106, Treas. Reg. § 1.79-0 (as amended in 1983). I.R.C. § 1372(a) excludes more-than-2% S corporation shareholders from such tax-favored treatment. I.R.C. § 1372(a).

262. *See supra* note 34 and accompanying text.

from the LLC in specific business settings.

The LLC will have a number of advantages over the limited partnership in the context of closely-held real estate ventures. While both the LLC and the limited partnership will enjoy the benefits of partnership tax treatment, the LLC will facilitate sharing of outside bases arising from liabilities among all the members[263] and thus the making of tax-free distributions of cash and property in which all members can participate. If qualified nonrecourse real estate financing is obtained,[264] the more balanced allocation of liabilities to members bases also will increase the amount of losses with respect to which all members will be entitled to a deduction.[265]

Furthermore, although no assurances can be given, the LLC may permit a member to materially participate in the management of the project, such that the member's income and loss from the LLC (other than, with limited exceptions, rental income and loss)[266] are active under the passive loss rules, without risking personal liability for the project's debts and obligations due to such activity.[267]

Structuring a computer software, bio-technology or other high technology enterprise as an LLC will yield a number of benefits. Limited liability is a high priority in such an enterprise due to the possibility of errors and omissions liability for technology malfunctions. The LLC or the S corporation, then, will be the appropriate entity.[268] If a software program, medical device or pharmaceutical is successful, entity-level taxation on the increased license fees for the technology or the appreciation recognized on the technology's

263. *See supra* text accompanying notes 210 and 211.

264. *See supra* note 198.

265. *See id.*

266. For a definition of rental activity, see I.R.C. § 469(j)(8) (1991) and Temp. Treas. Reg. § 1.469-1T(e)(3) (as amended in 1989).

267. However, members of an LLC may be unable to avoid personal liability outside of their membership capacities with respect to two principal sources of liability for real estate developers: acquisition debt and environmental compliance. Lenders probably will want personal guarantees from LLC members for loans used to acquire real estate. As stated above, environmental liability can be imposed on a managing member personally, based on his status as an "operator" of LLC property. *See supra* note 113 and accompanying text. However, an adequately capitalized LLC should insulate its members from tort creditors as well as routine trade creditors.

268. A C corporation would not be a desirable entity because undistributed license or royalty income of a C corporation may be subject to taxation at a 28% rate pursuant to the IRC's personal holding company provisions. *See generally* I.R.C. §§ 541-47 (1991).

sale[269] can be avoided using either the LLC or the S corporation.[270]

Beyond this similarity, though, the LLC will provide a number of advantages not available with the S corporation. Corporations and other business entities, as well as foreign individual investors who are not U.S. residents, will be able to make equity investments in a technology enterprise structured as an LLC. Membership interests with preferential distribution or conversion features may be offered without terminating pass-through income tax treatment. If the technology is patentable and the LLC either develops the technology from conception or acquires it before it is reduced to practice, the members of the LLC who are individuals will be entitled to long-term capital gain treatment on their allocable share of income arising from the sale of the technology, even if payments are periodic or contingent on productivity.[271] Furthermore, although no assurances can be given, the partnership classification of the LLC arguably may allow persons who do not have investment funds but who have valuable technical or other abilities to provide future services in exchange for a fully-vested interest in the LLC's profits without recognizing taxable income on the transaction.[272] Since ownership interests in these types of enterprises are almost always illiquid due to their high failure rate, the inability in an LLC to transfer all membership rights without the consent of the remaining members is not a substantial disadvantage.

Another situation in which the LLC may be the entity of choice is in a joint venture between large corporations. Large corporations typically participate in joint ventures by forming special purpose subsidiaries which serve as partners in a joint venture partnership. The subsidiaries provide the parent corporations with insulation from liability, while the partnership's pass-through treatment yields a more desirable income tax result than the dividends-received deduction that would be available if the parent corporations

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269. Generally, a sale of technology is deemed to occur upon the transfer of all substantial rights to the technology, even if such transfer is in the form of a license. *See, e.g.*, I.R.C. § 1235 (1991) (relating to transfers of patent rights).

270. This ability to avoid taxes assumes the S corporation does not have C corporation earnings and the income does not constitute "excess net passive income" of the corporation, which under IRC § 1375 will be taxed at the highest corporate rate. I.R.C. § 1375 (1991).

271. I.R.C. § 1235(a) (1991); Treas. Reg. § 1.1235-2(d)(2) (as amended in 1980). The Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11101, 1990 U.S. CODE CONG. & ADMIN. NEWS, 104 Stat. 400 (establishing a maximum ordinary income rate of 31% and a maximum net capital gains rate of 28%); *see* I.R.C. § 1(a)-(e), (i) (1991). In addition, an individual can use capital gains to offset capital losses that exceed $3,000 per tax year.

272. *See supra* note 202.

were to structure the venture as a corporation in which each participated as a shareholder.[273] In addition, use of an unincorporated entity for the venture entity allows large corporations to avoid disclosure and waiting-period requirements under the Hart-Scott-Rodino Antitrust Improvements Act.[274] A joint venture LLC by itself will provide the tax and liability advantages associated with the joint venture partnership owned by special-purpose subsidiaries, without the inconveniences associated with a tiered-entity approach. Also, since the LLC is an unincorporated entity, use of the LLC as the venture vehicle should not trigger Hart-Scott-Rodino disclosure and waiting-period requirements.

VII. Conclusion

The LLC represents the latest advance in business entities. Yet, because the Act borrows heavily from VSCA and VRULPA, many of its features already will be familiar to the Virginia practitioner. An LLC that is classified as a partnership and that is assured of limited liability in all jurisdictions will combine ownership, operational, tax and liability advantages in a way that its nearest relatives, the S corporation and the limited partnership, cannot. If tax classification and choice of law issues are resolved in the LLC's favor, it will no doubt become an often-used tool of the business planner.

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273. For example, if two corporations are 50% shareholders in a joint venture corporation, the joint venture corporation will be taxed on its income and will provide each parent corporation with a dividends-received deduction of 80%, leaving 20% of the dividend income taxable at both the joint venture corporation level and the parent corporation level. *See* I.R.C § 243(c) (1991). In contrast, if the venture is structured as a partnership in which each parent's wholly-owned subsidiary owns a 50% interest in the partnership, the partnership will pass-through its income equally to the subsidiaries. The income will be taxed at the subsidiary level, but each subsidiary, because it is at least 80%-owned by its parent, will provide a 100% dividends-received deduction to its parent. *See id.* § 243(a)(3). The result will be that income from the venture will only be taxable at one level: that of the parents.

274. 16 C.F.R. § 801.40 (1991) makes the Hart-Scott-Rodino Antitrust Improvements Act of 1976 [hereinafter Hart-Scott-Rodino Act], *codified as* § 7A of the Clayton Act 15 U.S.C. § 18a (1988 & Supp. I 1990), applicable to joint ventures in which a corporation is used as the venture entity. Hart-Scott-Rodino Antitrust Improvements Act of 1976, Pub. L. No. 94-435, § 201, 1976 U.S. CODE CONG. & ADMIN. NEWS 90 Stat. 1390; *see also* S. AXINN, B. FOGG. M. STOLL & B. PRAGER, ACQUISITIONS UNDER THE HART-SCOT-RODINO ANTITRUST IMPROVEMENTS ACT § 3.04[3][a] (1988) [hereinafter AXINN]. Transactions that are subject to the Hart-Scott-Rodino Act require, among other things, the filing of a notification with the Federal Trade Commission and the Justice Department accompanied by a $20,000 fee and the observance of a 30-day post-filing waiting period before closing the transaction. 15 U.S.C. § 18a(b)(1); Pub. L. 101-162, 103 Stat. 998 Section 605. For a more detailed discussion of these requirements, see AXINN, *supra*, at §§ 7.01 -8.05.