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²²Jeffrey A. Tannenbaum, *More Small Employees Must Adhere to Disabilities Act*, Wall St. J., July 25, 1994, at B 2.

²³WADE LAMBERT, *Have You Ever? New EEOC Guidelines for Job Interviewing Baffle Employers*, Wall St. J., July 15, 1994, at B1.

²⁴*Id.*

²⁵BARBARA PRESLEY NOBLE, *A Level Playing Field, for Just \$121*, N.Y. Times, March 5, 1995, at F21.

²⁶42 U.S.C. § 12111 (10) (1990).

INTRODUCING THE NEW
LIMITED LIABILITY COMPANY
TO THE CLASSROOM*

by
Peter M. Edelstein**

Introduction

Prior to October 24, 1994, if a small group of individuals desired to form a business they were forced to select from a variety of traditional but less than ideal options. On that date, New York State's new Limited Liability Company ("LLC") law became effective.¹ The legislation was designed to make available in a single business form, a combination of the most attractive business, legal and tax features. Entrepreneurs no longer have to compromise their primary objectives due to the limited choice of business forms.

The Limited Liability Company statute offers instructors an opportunity to introduce students to a timely and rather momentous piece of legislation by interpreting and illustrating its features through a process of comparison with the traditional business forms.

This paper will briefly review the history of the LLC, describe the classic categories of features by which the traditional business forms are analyzed, review the particular characteristics of the conventional business forms, compare the new LLC to those business forms, and highlight other features of the LLC. Appendix "A" contains a chart summarizing the comparisons. The sequence of topics in the paper mirrors the author's order of presentation in the classroom. The teaching methodology is designed to refresh and reinforce the students' existing knowledge of partnerships and corporations, and to critically analyze those business forms, thereby illustrating the utility of the LLC. Repeated comparisons of the features of the conventional business forms to each other and to the LLC provide the framework for the new information. I submit that our students will find learning about the LLC to be a graceful and natural extension of their knowledge of law because of their familiarity with the conventional business units. They will appreciate that the new law is a logical response to a real business need.

Brief History of LLC Legislation

New York was not the leader in the LLC movement; in fact, in July 1994, when then Governor Cuomo signed the enabling legislation², it was somewhat of a latecomer.

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Forty five states and the District of Columbia had already passed similar laws.³ Europe and South America for many years had enjoyed a limited liability business form which became the model for Wyoming, the first state to adopt an LLC statute in 1977.⁴ Six years later Florida adopted its statute,⁵ and then in 1988 the Internal Revenue Service issued a Revenue Ruling⁶ which blessed the LLC form with favorable tax treatment. That Ruling provided the necessary impetus for other states to rapidly follow the lead of Wyoming and Florida.

Analyzing the Classic Characteristics of Business Forms

Business forms have traditionally been studied by reference to categories of characteristics⁷. Students who have studied partnerships and corporations will recognize the categories and the available options: (i) liability, (ii) transferability, (iii) management, (iv) duration, and (v) tax treatment. Using these categories as a constant reference throughout the study of the LLC provides students with a comfortable and familiar structure to which the new LLC information can be related.

(i) *Liability* addresses the question of whether an individual participant may be *personally* liable for the debts of or claims against the organization, or is the organization's liability limited?⁸

(ii) *Transferability* refers to whether a participant without the consent of the others may substitute for him or herself a person who is not a participant, or is such transfer restricted?⁹

(iii) *Management* refers to whether "centralized" management exists; that is, the ability of a person or group (not including all the participants) to have continuing authority to make the management decisions necessary for the conduct of the business, or do the participants retain the authority to make the management decisions?¹⁰

(iv) *Duration* refers to the life span of the business unit. The issue is whether upon death, insanity, bankruptcy, retirement, resignation or exclusion of its participants, the business dissolves or does it have continuity of life?¹¹

(v) *Tax treatment* refers to whether the IRS will tax the business as a "partnership" or a "corporation".¹² A corporation is taxed (at the "entity level") when it earns income, and its shareholders are taxed when they receive that income in the form of dividends. A partnership is not taxed on its income which is "passed through"; its partners are taxed on their share thereof. For this reason a partnership is sometimes said to be "tax transparent". The IRS, holds that an unincorporated association, such as the new LLC, will be classified for federal income tax purpose as a partnership if the business form has "associates" (the LLC has) and an "objective to carry on a business and divide the gains among its association" (the LLC has) and *lacks* two or more of the following *corporate* characteristics: limited liability; continuity of life; free transferability of interest; and centralized management.¹³

Review of Features of Conventional Business Forms

The common field of choices of business units, historically consisted of: general partnership, limited partnership, "C" corporation, and "S" corporation. Their characteristics are:

1. General partnership (or "partnership")
 - **Liability:** No limited liability. The individual partners are ultimately liable for the debts of the partnership.
 - **Transferability:** Restricted. All partners must consent to the admission of a new partner, unless agreed to the contrary.
 - **Management:** No centralized management. Each partner has an equal right to participate in the management of the business, unless agreed to the contrary.
 - **Duration:** No continuity of life. It may be dissolved by the death, insanity, withdrawal or bankruptcy of any partner, unless agreed to the contrary.
 - **Tax treatment:** Beneficial. The IRS affords the partnership favorable tax treatment by imposing no tax at the business level; the partners are taxed on their share of the income of the business.
2. Limited partnership
 - **Liability:** Limited liability. The individual limited partners are not liable for the debts of the business. The general partner, however, is so liable. (To avoid this exposure many general partners exist in the corporate form).
 - **Transferability:** Restricted. There is no free transferability of the limited partner's interest. Transfers must comply with the terms of the applicable statute and the limited partnership agreement.
 - **Management:** Management is centralized in the general partner(s). Unlike the general partnership, the limited partners may *not* participate in the management of the business.

- **Duration:** Generally, the limited partnership is not dissolved upon the occurrence of the various events that cause the dissolution of the general partnership. It may be dissolved by agreement of the members or by court order.
- **Tax treatment:** Beneficial. The limited partnership is not taxed at the business level. The limited partners are taxed on their share of the income of the business.

3. C corporation (or "corporation")

- **Liability:** Limited liability. The individual shareholders are not liable for the debts of the corporation.
- **Transferability:** Free transferability. The interests of the shareholders are freely transferable, unless agreed to the contrary.
- **Management:** Management is centralized. The shareholders elect the directors; the directors appoint the officers. The directors set the corporate policy; the officers carry out that policy in the day-to-day operations.
- **Duration:** Continuity of life. The existence of the corporation is not affected by the death, insanity or bankruptcy of any shareholder.
- **Tax treatment:** The corporation is taxed on its income; the shareholders are taxed on their income. The same dollar can therefore be taxed twice: once when earned by the corporation as income; and again when distributed to the shareholder as a dividend.

4. S corporation

- **Liability:** Limited liability. The shareholders are not liable for the debts of the corporation.
- **Transferability:** Limited free transferability. The shares may be transferred subject to Internal Revenue Code restrictions as to who or what qualifies as a shareholder, and as may be otherwise agreed.
Management:
- **Management is centralized.** The shareholders elect the board. The board appoints the officers. The board makes policy decisions; the officers carry out the policy.

- **Duration:** Continuity. The S Corporation is not affected by the events that dissolve a partnership.
- **Tax treatment:** Beneficial. The shareholders enjoy the same type of "pass-through" tax treatment afforded the partnership and limited partnership; that is, no tax at the entity level, only at the member level.

Determination of Ideal Characteristics

A review of the classic characteristics of the conventional business forms prompts the students to appreciate the relative advantages and disadvantages inherent in each type of business unit and to conclude that each of the existing forms includes one or more shortcomings. They can then list and identify the ideal characteristics of a business form for a small group of entrepreneurs:

- **Liability:** limited; no personal liability for the debts of the business. A feature of the C and S corporation and limited partnership.
- **Transferability:** free transferability, coupled with the ability to restrict transfers if desired. A feature of the C and, to a limited extent S corporations.
- **Management:** no centralized management; flexible and easy management, without layers of decision makers, mandatory meetings and recordkeeping. A feature of general partnership.
- **Duration:** continuous life; not subject to dissolution for reasons beyond the participant's reasonable control. A feature of the C and S corporations. Or, if subject to dissolution, capable of reconstitution or continuation by agreement. A feature of the partnership and limited partnership.
- **Tax treatment:** "pass-through" tax treatment; that is, no tax imposed at the business level, with tax imposed only on the members. A feature of general partnership, limited partnership and S corporation.

While each of the forms of business existing prior to the LLC offered some desirable feature or features, only the limited partnership and the S corporation offered the dual advantages of limited liability and favorable tax treatment. Each of them, however, was encumbered with substantial disincentives.

The limited partnership requires at least one general partner which or who is personally liable for the debts of the business. If, in an attempt to avoid personal liability the general partner was in the form of a corporation, two sets of books and tax returns are required, a state franchise tax is imposed on the corporate general partner, and record-keeping chores multiply and costs increase. If the limited partners participate in

management they risk losing the shield of limited liability. The S Corporation, being a creature of federal law has several statutory limitations: it may have only one class of stock; it may not have more than 35 shareholders; it may not own more than 80% of another corporation; it may not have another corporation as a shareholder; and it may not have any non-resident alien as a shareholder.

Students can justly conclude that the time was right for a new and better business form.

The LLC and its Characteristics

The LLC is a non-corporate form of business. Participants are "members," not partners or shareholders. It offers in a single business unit, a composite of the most desirable business features without the customary limitations and drawbacks associated with the traditional business forms. The characteristics of the LLC are:

- **Liability:** Limited liability. Members enjoy the benefits of limited liability. The LLC is liable for its debts and obligations.¹⁴ Members are liable only to the extent of their capital contributions.¹⁵
- **Transferability:** Limited. A member may assign his or her interest but the assignee only receives the right to the assignor's share to distributions and profit and loss.¹⁶ An assignee does not become a member without the consent of a majority in interest of the members.¹⁷
- **Management:** No centralized management. Members may manage the business themselves¹⁸ or the members may vest management in a manager who or which does not have to be a member of the LLC.¹⁹
- **Duration:** No continuity of life. Dissolution occurs upon the happening of death, retirement, resignation, bankruptcy, dissolution or incompetence of a member, subject to the right, to be exercised within 180 days of any such event, to continue by unanimous consent of the remaining members.²⁰
- **Tax treatment:** Beneficial. There is "pass-through" tax treatment--no tax at the business level; the members are taxed at their personal rates.²¹

Other Features of the LLC

Formation. The LLC is formed by filing Articles of Organization²² with the Secretary of State and paying a \$200 filing fee.²³ The LLC must have at least one member.²⁴ Within 120 days of the filing there must be six consecutive weekly publications in two newspapers of general circulation.²⁵ An annual fee is imposed equal to \$50 times the number of members with a \$325 minimum and \$10,000 maximum.²⁶

Name of LLC. The name of the business shall contain the words: "Limited Liability Company", "L.L.C." or "LLC".²⁷

Operating Agreement. The members of the LLC shall adopt a written Operating Agreement that contains provisions not inconsistent with law or the LLC's Articles of Organization relating to (i) the business of the LLC, (ii) the conduct of its affairs, and (iii) the rights, powers, preferences, limitations or responsibilities of its members, managers, employees or agents, as the case may be.²⁸ This agreement is analogous to a partnership agreement and to corporate by-laws.

Voting rights of members. Unless agreed to the contrary in the Operating Agreement, each member shall vote in proportion to such member's share of the current profits.²⁹

Consideration for membership interest. The form of capital contribution may be in cash, property or services rendered or a promissory note or other obligation to contribute cash or property or to render services.³⁰

Nature of membership interest. The member's interest in the LLC is personal property. A member has no interest in specific property of the LLC.³¹

Withdrawal. Unless agreed otherwise in the Operating Agreement, a member may withdraw upon the vote or written consent of two-thirds in interest of the other members. Absent such vote or consent, a withdrawing member must give six months prior written notice. If such withdrawal violates the provisions of the Operating Agreement, the withdrawing member may be liable for damages.³²

Professional LLC's and Professional Limited Liability Partnerships. Both variations of the LLC are available.³³

Foreign LLC's. LLC's will be deemed domestic or foreign, as with corporations. Qualification is necessary for a foreign LLC to do business in New York.³⁴

Flexibility in drafting. The LLC statute is designed to afford an opportunity to customize the statutory scheme to meet the needs or desires of a particular venture.³⁵ Substantial latitude and flexibility is available in many areas including management, transferability of interests and continuity. If there is no agreement to the contrary, the statutory rules apply by default. In the default language of the statute, the corporate characteristics of continuous life and free transferability are sacrificed to invite the beneficial tax treatment. Because the New York statute is not "bullet-proof", extreme care must be taken when deviating from the statutory provisions. Since, by definition, the LLC will have limited liability, in order to enjoy the beneficial tax treatment of a "partnership", under IRC regulations, it must not have more than one more characteristic of a corporation.³⁶

Conclusion

The LLC is a good thing. It illustrates the logic and responsiveness of our legal process. A need was perceived and a solution was proffered. Our students should enjoy studying the LLC. Learning the material is at the same time a review and solidification of their existing knowledge and a new, yet continuing and natural learning experience.

While the LCC is not perfect,³⁷ it is a business form that must be seriously considered by all entrepreneurs interested in forming a small or closely held business venture.

ENDNOTES

¹Chapter 34 of the Consolidated Laws of New York State.

²Senate Bill No. 7511-A/Assembly Bill No. 11317-A.

³The only states without LLC legislation are Pennsylvania, Massachusetts, Vermont and Hawaii.

⁴Wyo. Stat. Ann. Sections 17-15-101 to 136 (Michie 1977).

⁵Fla. Stat. Ann. Sections 608.40 to -.471 (West Supp. 1990).

⁶88-76, 1988-2 C.B. 360.

⁷See for example, "Smith and Roberson's Business Law," Ninth Edition, Mann and Roberts, West Publishing.

⁸See Treas. Reg. 301.7701-2(d).

⁹See Treas. Reg. 301.7701-2(e)(1).

¹⁰See Treas. Reg. 301.7701-2(c)(1).

¹¹See Treas. Reg. 301.7701-2(b)(1).

¹²See Internal Revenue Code of 1986, as amended, Section 7701 and Treas. Reg. Sec. 301.7701-2(a)(1), *et seq.*

¹³Treas. Reg. Sec. 301.7701-2(a)(1).

¹⁴Ltd. Liab. Co. L. Sec. 201(m).

¹⁵Ltd. Liab. Co. L. Sec. 502.

¹⁶Ltd. Liab. Co. L. Sec. 603.

¹⁷Ltd. Liab. Co. L. Sec. 603(a)(3), 604.

¹⁸Ltd. Liab. Co. L. Sec. 401.

¹⁹Ltd. Liab. Co. L. Sec. 410.

²⁰Ltd. Liab. Co. L. Sec. 701.

²¹The New York statute's default provisions would qualify the LLC as a partnership for tax purposes based on similar statutes and Revenue Rulings in other states. To date there is no Revenue Ruling as to the New York LLC.

²²Ltd. Liab. Co. L. Sec. 206.

²³Ltd. Liab. Co. L. Sec. 203.

²⁴Ltd. Liab. Co. L. Sec. 203(c).

²⁵Ltd. Liab. Co. L. Sec. 206(8)(c).

²⁶Ltd. Liab. Co. L. Sec. 1101.

²⁷Ltd. Liab. Co. L. Sec. 204(a).

²⁸Ltd. Liab. Co. L. Sec. 417.

²⁹Ltd. Liab. Co. L. Sec. 402.

³⁰Ltd. Liab. Co. L. Sec. 501.

³¹Ltd. Liab. Co. L. Sec. 601.

³²Ltd. Liab. Co. L. Sec. 606.

³³Ltd. Liab. Co. L. Sec. 1203.

³⁴Ltd. Liab. Co. L. Sec. 802.

³⁵Ltd. Liab. Co. L. Sec. 401-420.

³⁶Treas. Reg. Sec. 301.7701-2(a)(1).

³⁷Some reservations concerning the LLC are as follows: (i) the LLC form in New York State is authorized to have only one shareholder; there has been no Revenue Ruling to date as to how this may affect the tax treatment; (ii) the publication requirement is cumbersome, and can be costly if, for example, publication is required in the New York Law Journal and the New York Times; (iii) the form is not readily suitable to large organizations due to the limitations on free transferability; (iv) there is still a question as to how the states without similar legislation will treat LLC's; (v) there is no established body of law to afford comfort and guidance to students or lawyers.