2003

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Daniel S. Kleinberger

Publication Information
13 Business Law Today 15 (November-December 2003)

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Abstract

In a children' book published in 1946, Ben Ross Berenberg described an imaginary amalgam called the churkendoose - "part chicken, turkey, duck and goose." In 1977, Wyoming invented a business law churkendoose: the limited liability company - part corporation, part general partnership, part limited partnership. That churkendoose has revolutionized the law of business organizations, becoming the vehicle of choice for tens of thousands of ventures every month and causing the IRS to radically overhaul its approach to taxing business entities. This article explores how preexisting regulatory and common law apply to LLCs and the related organizations known as limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs).

Keywords

Limited Liability Company, LLC, Limited Liability Partnership, LLP, Limited Liability Limited Partnership, LLLP, Corporations, Business entities, Business organizations, Business regulation, Common law

Disciplines

Business Organizations Law

Sorting Through the Soup: How do LLCs, LLPs and LLLPs Fit Withing the Regulations and Legal Doctrines?

Professor Daniel S. Kleinberger, William Mitchell College of Law

So many business organizations, so little time.

In a children' book published in 1946, Seri Ross Berenberg described an imaginary amalgam called the churkendoose – "part chicken, turkey, duck and goose." In 1977, Wyoming invented a business law churkendoose: the limited liability company – part corporation, part general partnership, part limited partnership. That churkendoose has revolutionized the law of business organizations, becoming the vehicle of choice for tens of thousands of ventures every month and causing the IRS to radically overhaul its approach to taxing business entities.

Even the venerable partnership has begun to develop churkendoose-like qualities. Twenty years ago, the notion of a limited liability general partnership would have been an oxymoron. Today, the limited liability partnership (LLP) is commonplace, and many states recognize limited liability limited partnerships (LLLPs). In an LLLP, not even the general partners are automatically liable for the limited partnership's debts.

These developments have given courts and counsel much to learn. More than one court has referred to an LLC as "a limited liability corporation" or to LLC members as shareholders, and one case referred to an LLC's members as "limited liability partners." In another case the court had to determine which long-arm statute to apply to an entity described in the contract as "United Restoration, LLC, A Florida Corporation."

Fortunately, vocabulary errors are rarely crucial. More problematic is how these new forms of business organization fit with legal doctrines, rules and contracts developed before the new forms saw the light of day.

With limited liability companies, the problem is gaps – that is, statutes, regulations and even private agreements that by their terms apply to specified business entities but do not mention LLCs. The problem is most likely to occur under statutes and rules that regulate business activity, and most often a "gap" will raise questions of coverage.

When a regulatory provision has an "LLC gap," the extent of the problem and complexity of the analysis depend on (1) whether the regulatory provision includes a "catchall" category of covered organizations; (2) if not, whether the provision seems designed to apply to all business organizations or to just a specified few, and (3) in either event, whether the provision treats partnerships and corporations alike.

Where the regulatory provision contains a catchall category, the issue of coverage is not a problem. For example, the California statute that requires criminal background checks for daycare providers is built around a licensing system that contemplates an applicant being an

individual or "a firm, partnership, association or corporation." Cal. Health & Safety Code, § 1596.871(b)(1)(E). In this context. An LLC is a "firm" or an "association" (or both) and therefore is certainly covered by the statute.

Likewise, LLCs clearly come within a Florida statute that provides: "A corporation, partnership, association or other entity that does business or contracts with a state agency, receives state funds, or claims a credit against any tax imposed by the state may not travel to or do business with any country located in the Western Hemisphere which lacks diplomatic relations with the United States." Fl. Stat. Ann. § 110.1155.

If the regulatory provision lacks a catchall category but has a general scope that does not distinguish between partnerships and corporations, the analysis involves an extra step of reasoning, but the outcome should be just as certain. An LLC is a churkendoose, a corporate-partnership hybrid, and should he classified with its antecedents.

That was the approach taken by a Connecticut court when it ruled that the Connecticut Unfair Trade Practices Act (CUTPA) does not apply to disputes among LLC members. The court first noted that the CUTPA does not apply to "the internal business affairs and workings of partnerships" and "intracompany disputes between officers and shareholders" and then held that the "present LLC case clearly involves an intraorganizational dispute in the same spirit as the above listed types of cases." *Sector Management Inc. v. Taurus Advisory Group Inc.*, 1998 WL 199353, at 2 (Conn. Super. Ct. Apr. 15, 1998).

The gap issue is not so simply resolved where the regulatory provision treats partnerships and corporations differently. In such situations, a court must first decide whether the provision allows extrapolation. If not, the inquiry ends; LLCs are not covered.

For example, when a single-member LLC invoked the Right to Financial Privacy Act in order to quash or modify a subpoena issued to the LLC's bank, a federal district court said no, categorically. The act delimits its scope with the word "customer," which is defined to mean "an individual or a partnership of five or fewer individuals." Noting that other courts had strictly construed the statutory definition and that the definition was not ambiguous, the district court stated: "A definition which declares what a term means excludes any meaning that is not stated … [A] limited liability company is plainly not covered by the plain meaning of the words 'individual or a partnership of less than five individuals.'" *Exchange Point LLC v. SEC*, 100 F. Supp. 2d 172, 174-175 (SDNY 1999).

Reported decisions on diversity jurisdiction have uniformly taken the same approach. The diversity statute's reference to "corporation" may not be expanded to include the limited liability company. Despite its corporation-like features, an LLC must be treated like any other unincorporated organization.

In contrast, when the regulatory provision des permit extrapolation, the gap-filling analysis usually involves three steps:

- identify the policies the provision seeks to advance,
- decide whether the corporate aspects or partnership aspects of an LLC are more relevant to those policies, and
- include or exclude LLCs from the statute accordingly.

An Oklahoma court of appeals decision illustrates this approach. The Oklahoma Constitution contains provisions on liquor licenses, which substantially predate and therefore do not mention LLCs. To determine whether an LLC could obtain a liquor license, the court first looked to the purpose of the constitutional provisions.

Noting that "the [Oklahoma] Constitution did not address all of the business formats as they existed at the time of adoption of the article on alcoholic beverages law and enforcement, and, significantly, … names only individuals and partnerships as those entities to which a license may be issued," the court concluded that the provisions' "evident purpose was the assignment of personal responsibility for compliance with the liquor laws." The court then identified the aspect of LLC status most relevant to the identified policy – the liability shield:

> The OLLC Act does exactly what its name indicates. It creates a form of business that has as its most important feature the limitation of liability of its members. This liability limitation is also a shield from the very responsibility and accountability that the constitutional provisions regarding alcoholic beverage laws and enforcement sought to impose.

In sum, in this context, an LLC is like a corporation, not a partnership, and may not have an Oklahoma liquor license. *Meyer v. Oklahoma Alcoholic Beverage Laws Enforcement Comm'n*, 890 P2d 1361, 1362-1364 (Okla. Ct. App. 1995).

In the context of federal bankruptcy law, the same mode of analysis has produced the opposite conclusion. In the first case to consider how an LLC member's bankruptcy affects the member's rights and status viz a viz the LLC, the judge wrote: "Like a partnership, members of the LLC have voluntarily associated in a business enterprise and the relationships among members may be personal in character. Indeed, there are very strict limitations on the transfer of a member's interest in the two LLCs involved in this case." The judge then stated: "My conclusions that an LLC and debtor's membership interest therein do no terminate on commencement of a Chapter 11 case by a member and that the LLC Articles and Agreements constitute an executory contract are supported, in analogy, by bankruptcy court interpretations in the area of partnership law" *In re Daugherty Constr. Inc.,* 188 BR 607, 6011, 614 (Bankr. D. Neb. 1995)

Another bankruptcy judge chose the same analogy, even while recognizing that a corporate-like liability shield is an essential attribute of an LLC:

> [T]he members of a Virginia limited liability company are not, solely by reason of their membership interest, personally liable for the company's debts, obligations, and liabilities. Nevertheless, for the purpose of

> analyzing the effect of a member's bankruptcy filing on the continued exercise of membership rights, it seems most appropriate to treat the relationship among members of a limited liability company as analogous to that of that among the partners of a partnership. In particular, the fact that membership interests in a limited liability company, unlike shares of stock in a corporation, are not freely transferable mirrors the restriction on entry of new members into a partnership, which ordinarily cannot occur without the agreement of all existing members. *In re Deluca*, 194 BR 65, 74 (Bankr. ED Va. 1996)

Sometimes the "compare and contrast" approach leaves the LLC in an in-between world. For instance, when a court considers whether an LLC interest is covered as "security" for the purposes of federal or state securities law, the liability shield is quite important. Although the shield does not transform an LLC interest into a share of stock, it does cut LLC interests off from a presumption of noncoverage that applies to ordinary general partnerships.

Under federal and most state securities laws, LLC interests are evaluated under the rubric of "investment contracts," where the key question is whether persons have contributed capital to an enterprise expecting to be essentially passive investors. Where an investment carries with it the risk of personal liability for the enterprise's debts, courts seem willing to presume, to the contrary, an expectation of *active* involvement. An LLC shield negates that presumption, making it easier to prove that LLC members invested with the expectation of profits being made chiefly through the efforts of others.

Sometimes the "LLC gap" in a regulatory provision poses a narrower and deeper type of coverage question – namely, which roles within an LLC fit the provision's regulatory paradigm. Consider, for example, Colo. Rev. Stat § 10-16-401(4)(c), which requires that every would-be Colorado health maintenance organization have an HMO certificate of authority and includes the following item in the list of information to be submitted with the application:

> A list of the names, addresses, and official positions of the persons who are to be responsible for the conduct of the affairs of the applicant, including all members of the board of directors, board of trustees, executive committee, or other governing board or committee, the principal officers in the case of a corporation, and *the* partners or *members in the case of a* partnership or *association*…

(Emphasis added.) In this context, "association" certainly encompasses LLCs, but does the section reference to "members" mean that a manager-managed LLC would have to list its non-managing members?

The provision's opening clause ("persons who are responsible") suggests that the answer should be no. Including members makes sense only if collectively they are "to be responsible for the conduct of the affairs of the applicant." In many manager-managed LLCs, the members

do have some residuum of management power, but that is also the case with corporate shareholders. The statute implicitly excludes mere shareholders (by referring to the board of directors) and should likewise exclude nonmanager members.

Common law concepts and equitable doctrines must also make room for the LLC churkendoose, and in this context the churkendoose has caused little difficulty. By its nature, a common law doctrine reflects policy, is not generally chained to the precise words of prior judicial expressions of that policy, and is properly re-articulated when new circumstances require. Equity is just as flexible, perhaps more so, since equity originated to do justice despite the constraints of legal form.

For example, courts have hardly paused to explain themselves in applying the successor liability doctrine to LLCs. The "rule and its exceptions as to successor liability apply regardless of whether the predecessor or successor organization was a corporation or some other form of business organization." *Libutti v. United States*, 178 F3d 114, 124-125 (2d Cir. 1999). Likewise, the equitable doctrine of piercing the "corporate" veil applies to LLCs, regardless of whether the applicable LLC statute so provides.

Thus, the LLC does not create gaps in judge-made law, it merely provides opportunities for judges to rearticulate established public policies in the light of new circumstances. However, when a dispute involves rules established by private contract, judges face a somewhat different problem.

Foley v. Aspen Ski Limited Partnership provides a good example. A limited partnership agreement provided for dissolution, termination and liquidation on "[t]he sale of all or substantially all of the assets of the partnership" except for the "sale of the assets of the partnership to a corporation organized solely for the purposes of continuing the business of the partnership in exchange for the corporation's capital stock." The limited partnership transferred its assets and liabilities to an LLC in return for a 49.8 percent membership interest in the LLC.

A limited partner asserted that the transfer triggered the dissolution/liquidation requirement, because an LLC is not a corporation. An appellate court rejected the assertion because it was not raised below, but mentioned in passing that the "argument may have merit." *Foley v. Aspen Ski Ltd. Partnership*, 208 F3d 225 (Table), 2000 WL 223549, at *4 (10th Cir. 2000).

Perhaps – but when unforeseeable circumstances arise (like the advent of a new form of entity), a strict, plain-meaning approach should not necessarily prevail. Like the existence of two ships named *Peerless, Raffles v. Wichelhaus*, 159 Eng. Rep. 375 (Ex. 1864), the invention of a new entity puts in play the question of the parties' intent.

Modern contract law gives courts ample power to determine that intent, and courts can use the same multi-layered mode of analysis they are using to address "LLC gap" issues in regulatory provisions. If the contract provision encompasses both partnerships and corporations and treats them alike, then the court should extrapolate the provision to cover LLCs.

If, in contrast, the contract provision distinguishes partnerships from corporations, or mentions one but not the other, the court should (1) discern the rationale behind the contract's approach; (2) determine which aspects of an LLC are relevant to that rationale and whether, given that rationale, an LLC is better analogized to a partnership or a corporation; and (3) include of exclude LLCs from the contractual provision accordingly.

Example: Assume that the limited partner in *Foley* timely argues that "an LLC is not a corporation" and the trial court determines that the purpose of the disputed provision is to allow transfer without dissolution to an entity that provides a full liability shield to all its owners. The court should then rule that the transfer to the LLC comes within the exception for transfers to a corporation.

Example: Assume instead that the trial court determines that a key aspect of the disputed provision is the change from partnership tax classification to taxation as a corporation. The court should then rule that the transfer falls outside the provision, unless the LLC has "checked the box" and elected to be taxed as a corporation.

As for limited liability partnerships and limited liability limited partnerships, gaps are usually not the difficulty. Partnership statutes define LLPs and LLLPs as merely subsets of their respective "partnership" categories, despite the radically new approach to general partner liability. As a result, a regulatory provision that refers to "partnerships" will automatically encompass LLPs and LLLPs.

This result is fine, so long as the provision functions to bring partnerships within the regulatory scope. The result may be problematic, however, if the provision exempts partnerships from coverage on the assumption that general partner liability makes regulation unnecessary or inappropriate.

For example, for many years the "anti-corporate farming" forces in Minnesota blocked every effort to permit LLCs to own agricultural land. In 1992, when Minnesota was adopting its LLC Act, more than 200 angry farmers showed up at a legislative hearing to denounce the LLC liability shield as inimical to the proper "stewardship" of the land. Only last year did LLC advocates finally manage to enact a "family farm LLC" amendment, under which family farm operations my use LLCs in the same ways and subject to the same structures that have applied for decades to "family farm corporations."

In the meantime, however, Minnesota had become the first state to provide for full-shield LLPs, and in 1999, when Minnesota's version of the Revised Uniform Partnership Act (RUPA) took effect, it became possible to accomplish "corporate" farming in Minnesota through the mechanism of a RUPA LLP. The opponents of corporate farming never knew what hit them, because their defensive wall was breached obliquely. Minnesota's ani-corporate, anti-LLC farming statute permits general partnerships to own agricultural land, and, according to RUPA, an LLP is merely a type of general partnership.

This “below the radar screen” problem is not limited to state law. For example, in 1999, the FTC’s Pre-Merger Notification Office (PNO) issued Formal Opinion 15, which explains how the Hart-Scott-Rodino Act’s pre-merger notification requirements apply to an LLC. At the same time, the PNO reiterated its longstanding view “that the formation of a partnership is not reportable and acquisitions of partnership interests that do not result in one person’s holding 100 percent of the interests in a partnership are nonreportable”—despite the fact the LLCs and RUPA LLPs are far more alike than different. 64 Fed. Reg. at 34, 807.

The problems discussed in this article are transient. Eventually, legislators and regulators will fully catch up. But for the moment, there are still hundreds of regulatory provisions dating from the good old days when entity choice meant “partnership or corporation” and every partnership had a personally liable general partner.

There is value to synchronizing “entity” law and regulatory law sooner rather than later. Any disconnect costs clients both in legal fees and in efficiency. “Open” questions are attractive to law professors and perhaps to litigators, but rarely to business people.

Those who practice “business entity law” can do a lot to bring regulatory law back into synch with entity law. The work can begin with three simple questions posed to colleagues who practice the law of regulation:

- Have “your” statutes and regulations been amended to take into account LLCs, LLPs, and LLLPs?
- In your area of regulation, does it matter whether a business is a partnership or a corporation?
- Does the regulatory scheme seem to care about the personal liability of a general partner?

The ensuing discussion will generate proposals for legislative and regulatory reform.

As for the thousands of existing contracts that might someday generate a *Foley*-type dispute—to the extent practical, lawyers should review their clients’ existing agreements, identify provisions that turn on specific types of business entities, and question how these provisions relate to LLCs, LLPs and LLLPs. For documents in electronic form, applying the “Find” function to words like corporation, shareholder, stock, share, partnership and partner should locate most places where a reference to LLCs, LLPs and LLLPs might be needed.

Being proactive here is important. It will almost always be easier to address these questions in advance and in the abstract, before circumstances cause the parties to have vested interests in conflicting answers.