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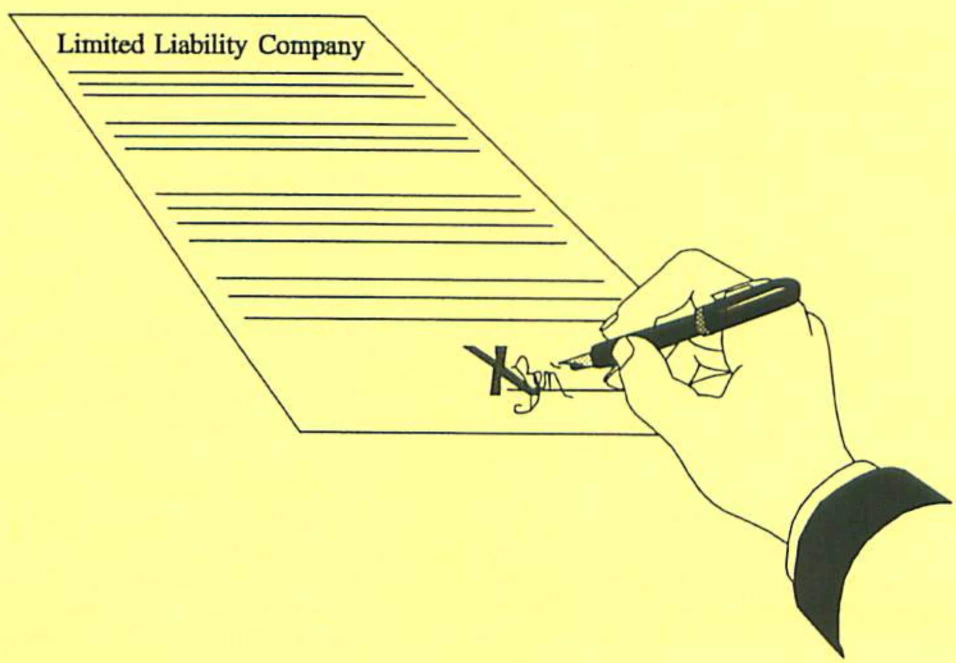

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LIMITED LIABILITY COMPANY-- AN ALTERNATIVE BUSINESS ORGANIZATION

by

Tracy L. Kolb, Jon E. Strinden, and David M. Saxowsky*

Highlights

Limited Liability Companies is a new business organization that

- combines the taxation of a partnership with the limited liability of a corporation;
- can facilitate the transfer of property ownership from one organization to another;
- offers an alternative for businesses involved in environmentally sensitive activities;
- must meet the same requirements as North Dakota farm corporations if the company engages in farming or ranching in the state;
- may not provide much opportunity to reduce self-employment tax; and
- will not change lenders' expectations that owners personally guarantee the repayment of the business' loans.

The 1993 North Dakota Legislature enacted a statute permitting the development of a new form of business organization call the Limited Liability Company (LLC).[1] This business organization combines the limited liability of a corporation with the pass-through income taxation of a partnership, but without many of the limitations associated with a limited partnership, S corporation, or other business organizations. Because of these desirable features, the LLC may well become the preferred form of business organization. This leaflet introduces the LLC form of business organization by describing its basic characteristics and comparing them to traditional business organizations, considering situations in which an LLC may be advantageous, and outlining the steps and requirements for forming an LLC.

Limited Liability Characteristic of LLCs

An LLC shields its members (owners) from personal liability for obligations of the LLC, whether the obligation arose from a contract entered into on behalf of the LLC or resulted from tort liability for an accident. This limited liability is like that of a corporate shareholder or limited partner, but unlike that faced by a general partner or a sole proprietor. Only the business assets of the LLC are "at risk," not the personal assets of the LLC member. Therefore an LLC member's liability is limited to that member's investment in the LLC or the amount that member has agreed to contribute to the LLC. An LLC member, however, can choose to be personally liable for some of the LLC's contractual obligations, such as personally guaranteeing a bank loan provided to the LLC.

An LLC member also could become personally liable for obligations of the LLC through the application a legal doctrine known as "piercing the corporate veil." Under this doctrine, if a corporation is formed or used for an illegal, fraudulent, or unjust purpose, the veil of limited liability is lifted; and the officers and directors are personally liable for the business' obligations.[2] The North Dakota law

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includes a provision that applies this doctrine to LLCs.[3] Personal liability is more often applied under this doctrine in tort actions than in contract actions.

Income Pass-Through Characteristic of LLCs

For federal and state income taxes, North Dakota's LLCs are to be treated as a partnership.[4] A partnership is a pass-through entity, meaning it is not subject to income tax at the entity level. Instead, all income and expenses are reported by the members in proportion to their ownership interests. This tax treatment avoids the C corporation disincentives of higher corporate tax rates and the potential for double taxation.

An S corporation also is a pass-through entity for tax purposes, but is subject to numerous restrictions that do not apply to LLCs. An S corporation must elect pass-through entity status and can have no more that 35 shareholders, who must be United States citizens, resident aliens, or certain estates or trusts. LLCs, however, do not have to elect limited liability status and are not limited in their number or type of members.

Even though the North Dakota statute provides that an LLC should be treated as a pass-through entity for income taxes,[5] whether the Internal Revenue Service (IRS) will acknowledge this status is uncertain.[6] To ensure the tax treatment of a pass-through entity, such as a partnership or S corporation, and to avoid the tax treatment of a C corporation, an LLC must lack two of the four corporate characteristics, which are

- continuity of life,
- centralization of management,
- limited liability, and
- free (unrestricted) transferability of interests.

North Dakota's LLC statute is drafted to assure that LCCs lack continuity of life and free transferability of interests.[7]

LLCs Lack Continuity of Life

A North Dakota LLC lacks continuity of life because it must dissolve no more than 30 years after its formation.[8] Other events that trigger dissolution include a member's death, retirement, resignation, expulsion, or bankruptcy, and transfer of a member's interest.[9] However, non-dissolving members may avoid terminating the business with a provision in the **articles of organization** for a **dissolution avoidance consent agreement** and a **business continuation agreement.**[10] These documents are explained in a subsequent section.

LLCs Lack Free Transferability of Membership Interest

Free (or unrestricted) transferability of interests exists when a member can transfer all of the attributes of that member's interest in the entity without the consent of the other entity members. To assure that North Dakota's LLCs lack free transferability, membership interest is divided into two components, financial rights and governance rights. Financial rights allow the LLC member to share in the LLC's profits and losses.[11] Governance rights encompass all rights as a member, except financial rights.[12] The North Dakota statute provides that financial rights are freely transferable, but governance rights may be transferred only with the unanimous consent of all LLC members.

The limitation on transferability of governance rights and the LLCs' limited existence and dissolution provisions should ensure that North Dakota's LLCs lack two of the four corporate characteristics and that they will be treated as pass-through entities for income tax purposes. North Dakota is currently obtaining an IRS revenue ruling on the tax treatment of North Dakota's LLCs. It is anticipated that the IRS will acknowledge the LLCs' tax treatment as a pass-through entity.

Terminology of LLCs

Articles of Organization--*the creating document of the LLC, setting forth information such as the name and address of the LLC; equivalent to a corporation's articles of incorporation.*

Board of Governors--*persons who govern the LLC; equivalent to the directors of a corporation.*

Business Continuation Agreement--*an agreement among the members governing the continuation of the LLC in a successor organization, which would arise as a result of a merger, transfer of assets, transfer of membership interests, or similar event.*

Contribution Agreement--*an agreement between a person and an LLC that the person will make a further contribution to the LLC and that the LLC will accept the future contribution; equivalent to a stock subscription agreement executed by investors in a corporation.*

Contribution Allowance Agreement--*an agreement between a person and a LLC that the person has a right, but not an obligation, to make a future contribution, and if the person makes a future contribution, the LLC will accept that contribution; equivalent to a stock option agreement executed by investors in a corporation.*

Dissolution Avoidance Consent Agreement--*an agreement among the members that if the LLC is terminated because of an LLC member's death, resignation, bankruptcy, or other event, the remaining members will continue operations in the existing LLC.*

Managers--*persons designated by the board of governors for general oversight of the LLC; equivalent to the officers of a corporation.*

Members--*owners of the LLC; equivalent to partners in a partnership and shareholders in a corporation.*

Membership Interest--*a member's interest in the LLC; equivalent to shares of stock in a corporation.*

Member Control Agreement--*an agreement among the members, setting forth the LLC's management, liquidation, dissolution, and termination; equivalent to a shareholder control agreement executed by the shareholders of a corporation.*

Operating Agreement--*the LLC's governing agreement setting forth its management and regulation; equivalent to a corporation's by-laws.*

Organizers--*one or more individuals who organize an LLC; equivalent to the incorporators of a corporation.*

Members' Participation in Management

LLC members do not give up management authority in return for the protection of limited liability, as limited partners must do in a limited partnership. Furthermore, North Dakota's LLC statute provides members the options of centralized management by a board of governors[13] or active participation in management by all members. Either option permits LLC members to actively or passively participate in the LLC's management without assuming personal liability for the LLC's obligations. These options are explained more fully in a subsequent section.

Potential Uses of an LLC

An LLC structure would be useful for any business in which the members want limited liability, pass-through income tax treatment, and participation in management. The following examples suggest some situations in which an LLC might be superior to other business forms.

Parents who own a family business could use an LLC to transfer ownership and management control to their children by gradually increasing the children's responsibility in the business. Such a gradual transfer can be accomplished by the parents initially transferring nonvoting membership interests to the children, but retaining control of the business with their voting membership interest. As the children gain responsibility, the parents could begin to transfer voting membership interest.

North Dakota law restricts LLCs involved in farming or ranching to, among other things, no more than 15 members who are United States citizens and related to one another, such as spouse, parent, child, and grandparent.[14] These are the same restrictions as the state's corporate farming law.[15] A non-farming or ranching LLC, however, is not subject to these restrictions.[16]

Venture capital firms and joint ventures could use LLCs to pool the capital of investors who want to form a business or who want to become involved in real estate, such as the purchase or construction of commercial property. Moreover, ownership of commercial property as an LLC may minimize environmental liability exposure under laws such as CERCLA (as known as Superfund). For example, forming a separate LLC to purchase an environmentally sensitive tract of land may be advantageous.

Professionals, such as doctors, accountants, and attorneys, also may find the LLC useful. The LLC offers the features of combining substantial member control with limited liability for the acts of co-members. In addition, international participants could use LLCs since members are not restricted on the basis of citizenship (except if the LLC is engaged in farming or ranching).

Forming an LLC

At formation, an LLC must have two or more members.[17] A member could be an individual and any domestic or foreign legal entity.[18] An LLC is formed in the same manner as a corporation; and the terminology associated with an LLC is similar to that of a corporation.

The creating document of an LLC is the **articles of organization**, which is similar to a corporation's articles of incorporation. The organizers of an LLC must file the articles of organization and submit the appropriate filing fee with the North Dakota secretary of state. The document requires the following information:

1. name of the company;
2. address of the principal office;
3. address of the registered office and the name of the registered agent;
4. name and address of each organizer;
5. limited time period of existence for the limited liability company (which must be 30 years or less from the date the articles are filed with the secretary of state);
6. whether the members will have the power to enter into a business continuation agreement.[19]

Though the above information is required, other standard provisions of the articles of incorporation,[20] such as the members' sharing of distributions or the frequency of members' regular meetings, may be modified by the organizers.[21]

The governing document of the LLC is its **operating agreement**. The operating agreement is similar to a corporation's by-laws and would contain information commonly found in corporate by-laws. The organizers can include in the operating agreement any provision relating to the management of the business or the regulation of the affairs of the LLC.[22] For example, with the operating agreement, the organizers could set forth the LLC's governance model, either the corporate model or the partnership model. The corporate model of centralized management consists of a board of governors and managers, who can be compared to a corporate board of directors and officers in their governing of the LLC's business affairs and general oversight of the LLC's management, respectively. The partnership model consists of direct management and active participation by the members.

Another important document is the **member control agreement**, which sets forth the management, liquidation, dissolution, and termination of the LLC.[23] The member control agreement also may provide for a business continuation agreement and a dissolution avoidance consent agreement, but only if the LLC members have provided for these agreements in the articles of organization.[24] The **business continuation agreement** governs the continuation of the LLC in a successor organization, which would occur as a result of a merger, transfer of assets, transfer of membership interest, or similar event.[25] The **dissolution avoidance consent agreement** allows LLC members to continue an existing LLC, even if a terminating event occurs and dissolution would normally result.[26] Under this agreement, dissolution is avoided if all the remaining LLC members give their consent.[27]

Other documents involved in forming an LLC are the member voting agreement,[28] the contribution agreement,[29] and the contribution allowance agreement.[30] The **member voting agreement** allows the LLC members to agree to the voting of their membership interests and to override the standard proxy provisions contained in North Dakota's LLC statute.[31] The **contribution agreement** and the **contribution allowance agreement** relate to LLC members making further contributions and the LLC accepting the future contributions.[32]

Forming an LLC is relatively simple. Much of the terminology is similar to that of a corporation or partnership. Likewise, those familiar with forming other business organizations will find that forming an LLC closely resembles forming a corporation or a partnership. Forming an LLC is complete when the secretary of state issues the certificate of organization.[33]

Ultimately, LLCs may replace other business organizations either through new business formations or conversions of existing business organizations into LLCs. Likely candidates for conversion are C and S corporations, and general and limited partnerships. Sole proprietorships cannot be converted into an LLC because an LLC must have at least two members at formation. Tax consequences will be the most important factor in deciding whether to convert an existing entity into an LLC. An attorney, accountant, or business adviser can help with forming an LLC or converting an existing organization into an LLC.

Miscellaneous Business Issues

Since the LLC is taxed as a partnership, the tax attribute of a partnership will apply to the LLC. This presents an opportunity for owners of closely held businesses to shift income and expenses among the members.

An issue which has received a great deal of attention is the nature of the income distributed out of an LLC. When LLCs were first introduced, the general consensus was that the owners could establish a salary subject to payroll taxes and that any distributions in addition to the salary would be unearned income and not subject to self-employment tax. At this time, the IRS's position on this matter is unclear. However, if the IRS adopts the initial general consensus, LLCs would be an alternative for managing self-employment tax because they distinguish earned (subject to self-employment tax) and unearned income.

Brief History of LLCs

The first LLC statute was passed in 1977 in Wyoming but there was limited interest primarily due to the uncertainty surrounding the federal income tax treatment of this new business organization. However, in 1988, the IRS issued Revenue Rule 88-76, 1988-2 C.B. 360, stating that Wyoming's LLC would be classified as a partnership for federal income tax purposes. This IRS ruling generated new interest in LLCs. More than 34 states have subsequently adopted LLC legislation, with the remaining states considering such legislation.

It appears that the Agricultural Stabilization and Conservation Service (ASCS) will treat LLCs in the same manner as limited partnerships. Therefore, an individual who owns more than a 50 percent interest in an LLC cannot use the LLC to qualify as a second entity for payment limitation purposes.

With respect to medical assistance planning and qualifying for Medicare benefits, the government considers all assets an individual owns in determining whether the person is eligible for medical assistance. Included in the assets would be any interest owned in an LLC.

Conclusion

The impetus behind passage of North Dakota's Limited Liability Company Act was economic development. As an alternative business form, the LLC fills an important gap in the available tools for attracting and encouraging the formation of businesses. With the flexibility and taxation of a partnership and the limited liability of a corporation, the LLC may offer substantial advantages in conducting business. Perhaps the LLC will have a positive impact on business activities in North Dakota.

Additional sources of information about Limited Liability Companies

Bosko, Marybeth. 1993. "The Best of Both Worlds: The Limited Liability Company." Ohio State Law Journal 54:175-198.

Keating, Robert R. et al. 1992. "The Limited Liability Company: A Study of the Emerging Entity." Business Lawyer 47:378-460.

Senate Judiciary Committee, Report on S.B. 2222, N.D. 53rd Leg. Sess. (January 25, 1993).

Strinden, Jon E. and James Bullis. 1993. "Legislative Review: Limited Liability Company Act." State Bar Association of North Dakota. The Gavel 40(5).

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Strinden, Jon E. 1993. "Conversion of Existing Entities Into LLCs." Limited Liability Companies: The Entity of Choice in North Dakota. Unpublished Continuing Legal Education material on file with the National Business Institute.

Wagner, Michael L. 1993. "Introduction To Limited Liability Companies (LLCS)." Limited Liability Companies: The Entity of Choice in North Dakota. Unpublished Continuing Legal Education material on file with the National Business Institute.

Endnotes

1. N.D. CENT. CODE ch.10-32 (Supp. 1993) (chapter 10-32 is the North Dakota "Limited Liability Company Act").

2. *Jablonsky v. Klemm*, 377 N.W.2d 560, 563 (N.D. 1985) (stating that the corporate veil will be pierced when the corporation is used to "defeat public convenience, justify wrong, protect fraud, or defend crime").

3. N.D. CENT. CODE § 10-32-29(3) (Supp.1993).

4. *Id.* § 57-38.1-17.2 (1993).

5. *Id.*

6. *Id.* (providing that a LLC will be considered a partnership for state income tax purposes if it is considered a partnership for federal income tax purposes). See also Michael L. Wagner, *Introduction To Limited Liability Companies (LLCS)* in Limited Liability Companies: The Entity of Choice in North Dakota, (1993) (unpublished continuing legal education material on file with National Business Institute).

7. N.D. CENT. CODE § 10-32-109-(1)(c) (Supp.1993).

8. *Id.* § 10-32-07(1)(e) (Supp. 1993).

9. *Id.* § 10-32-109(1)(c) (Supp. 1993).

10. *Id.* § 10-32-109 (Supp. 1993).

11. *Id.* § 10-32-02(17) (Supp. 1993).

12. *Id.* § 10-32-02(20) (Supp. 1993).

13. *Id.* § 10-32-69(1) (Supp.1993) ("The business and affairs of a limited liability company are to be managed by or under the direction of a board of governors.").

14. *Id.* §10-06.1-02 (Supp.1993) (Stating that, except as otherwise provided, farming or ranching by corporations and limited liability companies is prohibited); §10-06.1-12 (setting forth requirements under which a corporation or limited liability company may engage in the business of farming or ranching).

15. *Id.*

16. *Id.* §10-32-04 (Supp.1993) (stating that a limited liability company may be formed for any business purpose).

17. *Id.* §10-32-06 (Supp. 1993).

18. *Id.* §10-32-02 (28), (36), (32) (a member means a person with governance rights in the LLC; a person "includes an individual and an organization," and an organization means any domestic or foreign legal entity).

19. *Id.* § 10-32-07(1) (Supp. 1993).

20. See, e.g., N.D. CENT. CODE §10-32-07(2)(n) (Supp. 1993) (standard provision stating that "members share in distributions in proportion to the value reflected in the required record of the contributions of members"); §10-32-60 (Supp.1993) (sharing of distributions is according to standard provision unless otherwise provided in the articles of organization).

21. *Id.* §10-32-07(2), (3) (Supp. 1993).

22. *Id.* §10-32-68(1) (Supp.1993).

23. *Id.* §10-32-50(1) (Supp.1993).

24. *Id.* §§ 10-32-50(1)(d); 10-32-109 (Supp. 1993).

25. *Id.* § 10-32-02(7)(a) (Supp. 1993).

26. *Id.* §10-32-109 (1) (Supp. 1993).

27. *Id.*; see also §10-32-02(14) (defining "dissolution avoidance consent").

28. *Id.* §10-32-49 (Supp.1993).

29. *Id.* §10-32-58 (Supp. 1993).

30. *Id.* §10-32-59 (Supp. 1993).

31. *Id.* §10-32-49 (Supp. 1993).

32. See N. D. CENT. CODE §10-32-58 (provision for contribution agreements); §10-32-02(11) (definition of contribution agreement); §10-32-59 (provision for contribution allowance agreements); §10-32-02(12) (definition of contribution allowance agreement).

33. *Id.* §10-32-09 (Supp.1993) ("The limited liability company existence begins upon the issuance of the certificate of organization").