AN INTRODUCTION TO LIMITED LIABILITY COMPANIES

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I. History of LLCs

Limited liability companies ("LLCs") combine corporate and non-corporate elements. To many practitioners the LLC has become the business vehicle of choice for non-public enterprises.

The limited liability company can trace its origins to nineteenth century Germany in a 1892 German company law known as Gesellschaft mit beschrnkter Haftung (GmbH). The form was thereafter enacted into law is one form or another throughout Europe and Latin America. In the United States, several states passed legislation creating entities similar to the LLC as early as the last quarter of the nineteenth century.

The modern LLC in the United States was first adopted in 1977 in Wyoming. The Wyoming LLC Act permits the formation of LLCs organized for any lawful purpose except the business of banking and insurance. Wyo Stat §17-15-103.

The LLC generated sufficient interest in the United States in the years following the adoption of the Wyoming Act so that the National Conference of Commissioners of Uniform State Laws (NCCUSL) commenced consideration of a Uniform Limited Liability Company Act ("ULLCA") in 1992. It was adopted by NCCUSL in 1994. By that time nearly every state had adopted a LLC statute. Those statutes varied considerably in both form and substance. Many of those early statutes were based on the first version of the ABA Model Prototype LLC Act.

The ULLCA was revised in 1996 and consideration is being subject to further revision. The American Bar Association also drafted its own LLC model act known as the "Prototype Limited Liability Company Act ."

II. The State Statute

Limited liability companies are governed in California by the Beverly-Killea Limited Liability Company Act (Cal. Corp. Code §§ 17000-17655).

III. Comparison to Other Entities

A. Background

Generally, potential business owners will chose between one of five entities: sole proprietorship, general partnership, corporation, limited liability company, and limited liability partnership. Each entity has its own advantages and disadvantages.

B. Sole Proprietorship

A sole proprietorship is the simplest form. A sole proprietorship is not itself a legal entity, rather it is a term that refers to a natural person who directly owns a company and is directly responsible for its debts.

The advantages include the complete control and ease of formation. The sole proprietor may act through agents or employees. No documents need be filed with any government agency, although the business may still require licensing, permits, and insurance to meet the legal requirements imposed by the nature of the business it conducts.

A principal disadvantage is that the sole proprietor is liable for all acts of the business and does not benefit from a liability shield. The owner faces personal liability for all business losses and liabilities, including injuries caused by employees or other agents. If the owner is married, the couple's community property is also at risk.

C. General Partnership

A general partnership can be formed by a written or oral agreement. It is also the default business entity that exists when the business owners jointly engage in business for profit do not otherwise select an alternative form of doing business. Joint business owners may be deemed general partners, even if they have no specific intent to be "general partners" or have agreed how profits and losses will be shared. No special formalities are required to form a general partnership.

The advantages of a general partnership include the ability to act as a separate legal entity. The general partnership can hold and transfer real property and engage in litigation in its own name. It continues in existence notwithstanding the "dissociation" of one or more partners. The distribution of profits and losses of the general partnership are determined by the partnership agreement and may be allocated as determined by the partners, although absent a contrary agreement, the profits are shared equally.

Each has an equal right to participate in the management and control of the business. Absent a contrary agreement, disagreements as to matters that arise during the ordinary course of business are decided by

a majority of partners and extraordinary matters and amendments to the partnership agreement must have unanimous consent of the partners.

The disadvantages include unlimited personal liability for partnership obligations. As long as a general partner was engaged in behavior that occurred during the ordinary course of the partnership business, that partner is deemed to be an agent for the general partnership. As a result, all other general partners will be bound by a single partner's action done as part of the business and each partner is jointly and severally liable for the partnership's business obligations, despite how the general partnership agreement may have allocated losses.

D. **Corporation**

A corporation is a separate legal entity that is created and exists under specific authority granted by state law. It has its own identity, separate and apart from the persons who created it and from its shareholders.

The major advantage of selecting a corporation is its shield from personal liability for its shareholders. As long as all the requirements for forming and operating a corporation are met and maintained, shareholders will generally be able to manage and control the day-to-day operation of a corporation without losing their liability protection. Additionally, shareholders are not personally liable for the acts of the corporation simply by reason of their ownership interests in the corporation.

The liability shield can be lost if the corporation is deemed the "alter-ego" of its shareholders, or a "mere corporate shell." A court may allow a third-party claimant to "pierce the corporate veil" to satisfy claims from the shareholders' personal assets. It has been held that an individual shareholder may be liable under these circumstances where the corporation is not "only influenced and governed by that person, but that there is such a unity of interest and ownership that the individuality, or separateness, of such person and corporation has ceased, and that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice." (*Talbot v. Fresno-Pacific Corp.* 181 Cal. App. 2d 425 (1960) 431.) The following have considered in piercing the corporate veil:

(a) a commingling of funds;

(b) the treatment by an individual of the assets of the corporation as his own;

(c) the failure to obtain authority to issue stock;

(d) the holding out by an individual that he is personally liable for the debts of the corporation;

(e) the failure to maintain minutes of adequate corporate records;

(f) the identical equitable ownership in the two entities;

(g) the use of the same office or business location;

(h) the failure to adequately capitalize a corporation;

(i) the use of a corporation as a mere instrumentality for the business of an individual;

(j) the concealment and misrepresentation of the identity of the responsible ownership, management, and financial interest or concealment of personal business activities;

(k) the disregard of legal formalities;

(l) the use of the corporate entity to procure labor, services, or merchandise for another person or entity;

(m) the diversion of assets from a corporation by or to a stockholder, to the detriment of creditors;

(n) the contracting with another with intent to avoid performance by use of a corporate entity as a shield against personal liability;

(o) the formation and use of a corporation to transfer to it the existing liability of another person.

(*Associated Vendors, Inc. v. Oakland Meat Company, Inc., et al.* (1962) 210 Cal.App.2d 825)

2. C-Corporations

A "C-Corp" is governed by sub-chapter C of the Internal Revenue Code. The C-Corp is subject to double-taxation, since taxes are collected from a corporation's profits and again from shareholders when those profits are distributed as dividends. A corporation can sometimes avoid double taxation through salary payments to employees, provided the amounts are reasonable, because salaries are a deductible expense of the corporation. It is the default form of a corporation.

3. S-Corporations

An "S-Corp" is governed by sub-chapter S of the Internal Revenue Code. Unlike a C-Corp, an S-Corp is taxed as a partnership and is only subject to one level of taxation. Additionally, like a partnership, the S-Corp will not file separate tax returns, rather; the profits and losses by the S-Corp should be accounted for on the individual shareholder's income returns.

S-Corps are also not subject to the additional annual franchise tax of limited liability companies formed in California. An S-Corp may have no more than 75 shareholders, all of whom must be U.S. citizens or residents, or certain 'electing small business' trusts.

An S-Corp may only have one class of stock.

4. Close Corporations

In California the words "close corporation" or "statutory close corporation" are terms of art, referring to a specific type of organization available to some closely held corporations. Ordinarily, close corporations are also S-Corps, but the two terms should not be used interchangeably. An S-Corp is an entity recognized under the IRS code, while close corporations are recognized under state law.

California permits close corporations to adopt special rules to modify the "default" provision of the Code, such as division of profits, allocation of control over corporate affairs, and corporate procedural formalities. In effect, the shareholders may enjoy much of the flexibility of a partnership with the limited liability of a corporation.

In addition to the standard requirements for incorporation, a close corporation must: (1) have a written agreement among all shareholders setting forth the matters upon which the shareholders will exercise control; (2) have no more than 35 shareholders; (3) the articles of incorporation must contain: (i) a provision that all of the corporation's issued shares of all classes shall be held of record by not more than a certain number (not to exceed 35); and (ii) the statement, "This corporation is a close corporation."

E. Limited Partnership

Limited partnerships are authorized pursuant to the California Revised Limited Partnership Act (Cal. Corp. Code, §§ 15611-15723) which applies to limited partnerships formed on or after July 2, 1984 or limited partnerships that elect to be governed by that act. Generally limited partnerships consist of one or more general partners who manage the business and are subject to personal liability for partnership obligations and one or more limited who typically contribute capital for a share of the profit.

Generally, if properly managed, each limited partner's liability is limited to that individual's capital contribution. The limited partners as investors have various rights to records and information, (but participation in management, may expose a "limited partner" to a general partners liability. A limited partnership may be organized with a corporation or limited liability company as the general partner.

F. Limited Liability Partnership

Limited Liability Partnership (LLP) can be thought of as a general partnership with the added feature of a corporate-style limited liability shield for its partners. It is used in lieu of a limited liability company (LLC) for those entities (law, accounting, and architectural firms) statutorily prohibited from being organized as a LLC. By registering as an LLP, the general partners can limit, but not necessarily eliminate, liability for the partnership's obligations and debts.

In California, the LLP is only available to partnerships engaged in the practice of law, public accountancy, or architecture and those providing services or facilities related or complementary to those provided by such firms. Additionally, the partnership must be registered with the state and provide liability insurance, collateral, or have a specified net worth to be allowed limited liability status.

G. Limited Liability Companies

1. Overview

A limited liability company (LLC) is a unique business entity that offers the benefits of a partnership and corporation without the regulation or rigidity of a limited partnership and S-Corps. It combines the pass-through tax treatment of a partnership with the general limited liability protections of a corporation.

A LLC is a separate legal entity. A single person may establish a LLC. The owners of a LLC are referred to as "members." Members may manage the LLC themselves or elect a manager or managers. A California LLC may not engage in businesses required to be licensed, certified, or registered under the

Business and Professions Code. Insurance Code §§ 1647 and 1647.5 permit insurance agents and brokers to conduct businesses as a LLC subject to certain requirements.

A LLC comes into existence with the filing of appropriate Articles of Organization with the Secretary of State unless expressly authorized by Corp. Code § 17375. Members must enter into an Operating Agreement which is an agreement among the members to organize the LLC. The Operating Agreement can restrict or enlarge the rights of the members regarding the management and control of the LLC.

2. General Considerations Indicating Suitability of LLCs

Generally, a LLC is selected as the business entity when potential business owners desire the flexibility of a partnership and the liability shield of a corporation, but do not want certain burdens associated with each. Members of an LLC may chose to have the entity taxed as a corporation or as a pass-through entity (like a partnership) that avoids double taxation. However, LLCs do not have the restrictions placed on S-Corps and limited partnerships. Thus, each member may be involved in the day-to-day operations and still enjoy limited liability and there is no limit on the number or type of members.

There are two basic approaches to the management of LLCs: (1) members of the LLC can run the daily operations of the entity, or (2) members may hire a manager or mangers to do so.

a. Member Managed LLCs

In a member managed LLC, all members have a right to manage and control the entity subject to any limitations or grants in the Article of Organization or the Operating Agreement. The members are then subject to the same fiduciary duties and obligations as is any manager.

b. Manager Managed LLCs

For a LLC to be managed by managers, the Articles of Organization must state that the LLC is to be managed by one or more managers. The Articles, however, do not have to state the names of the managers, only that the LLC will be managed by managers as opposed to members. Managers may be do not need to be a natural person or members of the LLC.

3. Fiduciary Duties

The scope of fiduciary duties owed by LLC members and managers to the LLC and its members is unsettled, particularly in cases where the LLC Agreement purports to reduce fiduciary duties below the level established by the default rules. (Marsh's California Corporation Law (Aspen 2003) § 3.05[E])

The LLC Act differentiates between member-managed limited liability companies from manager-managed limited liability companies.

a. Member Managed LLCs

The LLC Act provides that, "Unless the articles of organization include the statement referred to in subdivision (b) of Section 1751 vesting management of the limited liability company in a manager or managers, the business and affairs of a limited liability company shall be managed by the members subject to any provisions of the articles of organization or operating agreement restricting or enlarging the management rights and duties of any member or class of members. If management is vested in the

members, each of the members shall have the same rights and be subject to all duties and obligations of managers as set forth in this title." (Cal. Corp. Code § 17150)

Fiduciary duties of loyalty and care owed by general partners to each other and the partnership should be incorporated by the provision that the members shall be subject to all "duties" as set forth in the California Partnership Act (Cal. Corp. Code §§16100-16962) because section 17153 provides, "The fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership." Since both the duty of loyalty and the duty of care are specific fiduciary duties of partners under the California Partnership Act these duties apply to all members in a California member managed LLC.

While the issue has not been decided, it may be reasoned that the obligation good faith which is also encompassed in the California Partnership Act is also an "obligation" incorporated by Corp. Code § 17153 or as a concomitant of contracts generally.

b. Manager Managed LLCs

In a manager managed LLC, managers owe the same fiduciary duties of care and loyalty to the LLC and all its members as are owed by a partner in California to a partnership and its partners. (Cal. Corp. Code § 17153). These duties may be modified, although the extent of permissible modification is uncertain, in a written operating agreement with the members' informed consent. (Cal. Corp. Code § 17005(d)). A written agreement may also provide for the appointment of officers of an LLC unless otherwise provided are appointed by the manager(s) of the LLC. (Cal. Corp. Code § 17154(b)).

The Beverly-Killea Limited Liability Company Act does not specifically address the fiduciary duties of a non-managing member of a manager managed LLC. It does, however, specifically provide that a member may lend money to and transact other business with the LLC and, "subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a member." (Cal. Corp. Code § 17004(a)). Arguably, this is authority that would limit a non-managing member's fiduciary duties.

c. Waiver

It is uncertain to what extent, members can by agreement waive the fiduciary duties in a LLC.

Cal. Corp. Code § 17005 appears to permit members to waive their fiduciary duties, except to the extent that the members are managers. It provides broad (but not unlimited) authority for members to contract concerning their relationships with each other, even to the extent of varying the provisions of Cal. Corp. Code § 17153 which otherwise incorporates the duties and obligations of partners.

Cal. Corp. Code § 17005(d) however provides that with respect to managers that, "The fiduciary duties of a manager to the limited liability company and to the members of the [LLC] may only be modified in a written operating agreement with the informed consent of the members." However, Cal. Corp Code § 17153 incorporates the duties of a general partnership ("The fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership.") The interplay between those two sections and Cal. Corp. Code § 16103(b) (which generally limits the ability to waive certain duties in a partnership agreement) is unclear. Arguably section 17005(d) which basically provides that you one can waive the duties by agreement, should be applied to

the LLC context because section 17005(d) is part of the LLC Act. An additional rationale may be offered based on the rule of interpretation that the more specific provision should govern. At present, the matter remains unresolved.

IV. Advantages of LLCs

Members are typically protected by a liability shield. Generally, only the LLC itself is legally responsible for the entity's debts. With very limited exceptions, LLC members are not personally liable for the debts or obligations of the LLC and enjoy same limited liability as corporate shareholders.

The members may face personal liability under the guarantor liability and "alter ego" liability theories. Under guarantor liability, the LLC members will be personally liable for the entity's obligations if they personally guaranteed the obligation. Additionally, under "alter ego" liability, a member may be found liable for an LLC's obligations under the common law "alter ego" doctrine. A difference in LLC "alter ego" analysis and the analysis for a corporation, is that failure to hold or observe formalities pertaining to calling or conducting of meetings is not a factor tending to establish that a member or members have alter ego or personal liability for any debt, obligation, or liability of the LLC if the Articles of Organization or Operating Agreement do not expressly require the holding of meetings of members or managers. This "exception" to corporate style alter ego analysis does not apply to liability for the member's participation in tortious conduct or pursuant to a written guaranty or other contractual obligation entered into by the member, other than an Operating Agreement (Cal. Corp. Code § 17101).

CHOICE OF ENTITY CONSIDERATIONS

Topic	C Corporation	S Corporation	Limited Liability Company	Limited Partnership	General Partnership
Ease or Difficulty of Formation; Transaction Costs	In California, Articles of Incorporation must be filed with the Secretary of State Statement of Domestic Stock Corporation must be filed with the Secretary of State within 90 days after filing the Articles. The parties need not negotiate a detailed agreement governing the structure and operation of the corporation, but can instead, rely on the General Corporation Law. However, if the parties desire to restrict the transferability or voting rights of stock, or provide for different classes of stock, a detailed agreement or specially-drafted Articles of Incorporation may be required. After formation, directors must be elected, officers appointed, Bylaws prepared and adopted, and shares of stock issued, all of which (plus other organizational matters) should be reflected in organizational minutes.	In California, Articles of Incorporation must be filed with the Secretary of State Statement of Domestic Stock Corporation must be filed with the Secretary of State within 90 days after filing the Articles. The parties need not negotiate a detailed agreement governing the structure and operation of the corporation, but can instead, rely on the General Corporation Law. However, if the parties desire to restrict the transferability or voting rights of stock, or provide for different classes of stock, a detailed agreement or specially-drafted Articles of Incorporation may be required. After formation, directors must be elected, officers appointed, Bylaws prepared and adopted, and shares of stock issued, all of which (plus other organizational matters) should be reflected in organizational minutes.	In California, an LLC is formed by filing Articles of Organization (Form LCC-1) with the Secretary of State Within 90 days after filing the Articles, the LLC must file a Statement of Information with the Secretary of State. All members must enter into an Operating Agreement. Although oral agreements are permitted, the agreement should be in writing. The cost and complexity of the agreement will depend on the nature of the LLC and its business. Drafting the agreement may be more time-consuming and costly than drafting simple articles and bylaws for a corporation.	In California, a limited partnership is formed by filing with the Secretary of State a Certificate of Limited Partnership (Form LP-1) executed by all the general partners. Although oral agreements are permitted, the Limited Partnership Agreement should be in writing. The cost and complexity of the Partnership Agreement will depend on the structure and business of the partnership. Drafting the Agreement may be more time-consuming and costly than drafting simple articles and bylaws for a corporation.	In California, no filing fee is required to form the entity. Partners should, but need not, enter into a General Partnership Agreement. The cost and complexity of the Agreement depends on the structure and business of the partnership. Drafting the General Partnership Agreement may be more time-consuming and costly than drafting simple articles and bylaws for a corporation.

Topic	C Corporation	S Corporation	Limited Liability Company	Limited Partnership	General Partnership
Agency Authority of Owners and Management	Officers are agents of the corporation. Neither shareholders nor directors have agency authority to bind the corporation.	Officers are agents of the corporation. Neither shareholders nor directors have agency authority to bind the corporation.	In a member-managed LLC, every member is an agent of the LLC, and the act of any member, for apparently carrying on in the usual way the business of the LLC, binds the LLC. In a manager-managed LLC, (1) every manager is an agent of the LLC, and the act of any manager, for apparently carrying on in the usual way the business of the LLC, binds the LLC, and (2) members are not agents of, and cannot bind, the LLC. The Articles of Organization or the Operating Agreement may limit the authority of members (in a member-managed LLC) or managers (in a manager-managed LLC) to bind the LLC. However, such limitations will not be effective against third parties without actual knowledge of the restrictions.	General partners are agents of the limited partnership. Limited partners do not have apparent agency authority to bind the partnership.	Each partner is an agent of the partnership. The act of any partner for apparently carrying on in the usual way the business of the partnership binds the partnership. The Partnership Agreement may restrict the authority of a particular partner to bind the partnership; however, a restriction on authority will not be effective against third parties who have no knowledge of the restriction.

Topic	C Corporation	S Corporation	Limited Liability Company	Limited Partnership	General Partnership
Liability of Owners for Business Obligations	Shareholders are not liable for the obligations of a corporation. However, shareholders may be liable (1) to the extent they personally guaranty corporate debts; (2) to the extent they receive improper distributions; (3) if a court "pierces the corporate veil" of a corporation to impose personal liability on the shareholders; or (4) if a controlling shareholder breaches a duty to the other shareholders or the corporation.	Shareholders are not liable for the obligations of a corporation. However, shareholders may be liable (1) to the extent they personally guaranty corporate debts; (2) to the extent they receive improper distributions; (3) if a court "pierces the corporate veil" of a corporation to impose personal liability on the shareholders; or (4) if a controlling shareholder breaches a duty to the other shareholders or the corporation.	Members of an LLC are not liable for the obligations of the LLC. However, a member may be liable (1) to the extent he or she personally guaranteed debts of the LLC; (2) for the member's participation in tortious conduct; (3) with respect to distributions from an LLC made in violation of the LLC Act; and (4) if a court "pierces the company veil" of an LLC to impose personal liability on the member. The criteria used to determine whether to "pierce the LLC veil" are the same criteria used to determine whether to pierce the corporate veil, except that the failure to hold meetings of members or managers or to observe formalities pertaining to meetings will not be considered a factor if the LLC is not required to hold meetings of members of managers.	The general partner is liable for partnership obligations to the same extent as partners of a general partnership. Limited partners are not liable for partnership obligations and risk only the loss of their agreed capital contribution. Limited partners may become liable as general partners if they participate in the management of the partnership business.	Partners are jointly and severally liable for the wrongful acts or omissions of any partner acting in the ordinary course of partnership business or with authority of the partners, and are jointly liable for all other obligations of the partnership.