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# New Limited Liability Company Legislation in New York

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NEW LIMITED LIABILITY COMPANY LEGISLATION IN NEW YORK

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On July 26, 1994, Governor Cuomo signed legislation which will permit limited liability companies to be formed in New York State.<sup>1</sup> When the law became effective October 24, 1994, New York was the 42nd state to enact an LLC statute.<sup>2</sup>

The limited liability company ("LLC") is a new form of doing business which combines the advantages of a partnership's flow-through tax treatment and operating flexibility with a corporation's limitation on liability for shareholders.

The LLC is potentially useful for businesses in which the owners desire limited liability, flow-through tax treatment, and control over management. LLCs are particularly well-suited for foreign investment, venture capital, joint venture, real estate, oil and gas and high technology transactions, as well as for family-owned and other closely-held businesses. LLCs are not likely to be attractive when it is expected that the interest of the business will be widely-held or publicly traded, because flow-through tax treatment is unlikely to be available to such business.

#### History

A form of doing business similar to the LLC has existed in European and South American countries for many years. In 1977, Wyoming became the first state in the United States to enact an LLC \*204 statute. Five years later, Florida became the second state to enact an LLC statute. One of the primary purposes of these statutes was to attract new capital. Between 1977 and 1988 not many LLCs were formed, however, because of the uncertainty concerning the tax treatment of LLCs.

In 1988, the Internal Revenue Service issued a Revenue Ruling<sup>3</sup> which favorably classified a Wyoming LLC as a partnership for federal income tax purposes. With clarification of the critical issue, other states began to recognize the value of the LLC and adopt LLC legislation. Since 1988, a total of thirty-five additional states have enacted legislation recognizing LLCs.

A committee of the American Bar Association Section of Business Law has drafted a prototype LLC statute and a committee of the National Conference of Commissioners on Uniform State Laws is drafting a uniform LLC law.

#### Business Law Aspects

LLCs are non-corporate businesses that provide their members with limited liability and allow them to actively participate in management of the business. Although specific provisions may vary from state to state, most LLC statutes have the following features in common:

##### 1. Limited Liability

One of the primary benefits of the LLC is that it provides an alternative to the corporation as an entity which provides owners with limited liability. As in the corporate context, members of LLCs are generally liable only to the extent of their capital contribution to the LLC. It is possible that the theory of "piercing the veil" may apply to LLCs as it does to corporations but the risk of liability exposure under such a theory should be no greater for LLC members than for shareholders in a corporation. The limited liability feature differentiates LLCs both from general partnerships, in which all partners are liable for the debts of the partnership, and from limited partnerships, in which at least one partner (the general partner) is liable for

the debts of the partnership.

## 2. Control Over Management of the Business

Presently, all but one of the LLC statutes allow the members to manage the business of the LLC. In addition, all of the LLC statutes provide that the members may elect managers, who may be, but are **\*205** not required to be, members, to manage the business of the LLC. The ability of the members to directly manage an LLC differentiates LLCs both from corporations, in which shareholders are passive investors, and from limited partnerships, in which limited partners risk losing their limited liability protection by participating in the management of the limited partnership.

## 3. Finance and Management Structure

LLCs are generally not subject to the same finance and management limitations that traditionally bind corporations. For example, LLCs are not required to create a surplus account for dividends, provide for management by a board of directors, issue stock or hold annual shareholder or board of directors meetings.

### Comparison To Other Business Forms

The following discussion briefly compares LLCs, corporations, limited partnerships and general partnerships.

#### 1. Comparison To Corporations

##### a. Formation

LLCs, like corporations, are formed through a central state agency filing. In New York, this is accomplished by filing articles of organization with the Department of State.<sup>4</sup> In New York an LLC may have only one member.<sup>5</sup> This single member feature is distinguishable from all the other states where a minimum of two members are required. The IRS has not ruled on a one member LLC. Accordingly it is recommended that the LLC be organized with at least two members.

##### b. Governing Documents

In a corporation, there are often numerous documents which govern the relationship of the members to the entity and to each other, and set forth rules concerning the operation of the entity. However, an LLC more closely resembles a partnership. In an LLC, these relationships are altered by an agreement among the parties referred to as an "operating agreement." In New York, virtually all of the provisions prescribed by the LLC statute may be changed by the parties through the medium of the operating agreement.<sup>6</sup> Although, as with all contracts, it is good business practice to memorialize the terms of operating agreement in writing, this is not required.

##### **\*206** c. Capital Structure

LLCs generally afford more flexibility in capital structure than corporations. For example, LLCs do not have rules requiring the issuance of shares or the determination of classes and series within any such issuance. A member's interest in an LLC need not be evidenced by any type of certificate;<sup>7</sup> instead, the receipt of an LLC membership interest is merely recited as consideration for the capital contribution recorded in the LLC's records.

##### d. Capital Contributions

A member's capital contribution may be in the form of cash, property, services rendered or a promissory note or other obligation to contribute cash or property or to provide services.

##### e. Transfer of Interests

In the corporate context, shares of stock are freely transferable under state law, unless restricted by agreement. By comparison, unless the operating agreement provides otherwise, only the financial or economic rights of a member in the

LLC are freely transferable.<sup>8</sup>

f. Management

Corporation statutes provide for management by a board of directors on behalf of passive shareholders. In New York, all members of the LLC have the right to act as agents of the LLC and manage its affairs unless the articles of organization specifically provide otherwise.<sup>9</sup> However, even in those cases where the parties decide not to take away the presumption that all members are agents of the LLC, the operating agreement may still create a representative management structure.

g. Dissolution

Corporate statutes usually provide for dissolution upon a vote of directors and shareholders, followed by a formal filing of articles of dissolution (or other equivalent documents). By comparison, unless the operating agreement provides otherwise, a New York LLC will dissolve upon the death, retirement, resignation, bankruptcy, dissolution or incompetence of a member, subject to an option to continue the LLC by the unanimous consent of the remaining members.<sup>10</sup>

**\*207** h. Merger

The New York LLC Act provides for mergers between LLCs and other types of entities.<sup>11</sup> These merger provisions are significant because they provide a mechanism by which existing corporations and partnerships can easily convert into LLCs. For federal tax purposes, however, mergers under these statutes will not be treated as tax-exempt reorganizations.

i. Foreign LLCs

Most LLC statutes explicitly recognize LLCs organized in other states, including the limited liability provisions of the LLC's jurisdiction of organization, and provide procedures by which foreign LLCs can qualify to do business in the state.<sup>12</sup> No cases have yet addressed, however, whether the limited liability protection offered by the jurisdiction of organization will be recognized by a state not having an LLC statute. Nevertheless, under choice of law rules, the common law principles of comity and the Due Process Clause and Full Faith and Credit Clause of the United States Constitution, courts may be expected to look to an LLC's jurisdiction of organization to determine the liability of members and managers, thereby according limited liability to foreign LLCs.

2. Comparison to Limited Partnerships

LLCs are quite similar to limited partnerships. The principal difference between LLCs and limited partnerships, however, is that LLCs do not have a general partner. As a result, while limited partnerships are managed by one or more personally liable general partners, LLCs are managed by members or managers who have no personal liability. In addition, while limited partners may lose their limited liability protection by participating in the management or control of the business of the limited partnership, members of LLC do not lose their limited liability protection merely by participating in management or control of the business of the LLC. Many practitioners routinely form a limited partnership with a corporate general partner in order to create a structure which combines limited liability for investors with partnership tax treatment. An LLC, if correctly formed, can achieve the same result without the formation of a corporate general partner.

**\*209** 3. Comparison to General Partnerships

a. Liability

The obvious and most important distinction between LLCs and general partnerships is that the general partner in a partnership is personally liable for the debts of the partnership, whereas the members of an LLC have limited liability.

b. Formation

As noted above, LLCs are formed by filing articles of organization with the Department of State which serve to notify third parties of the limited nature of the entity. By comparison, general partnerships are formed by the agreement of the partners

and are not subject to any filing requirement.<sup>13</sup>

c. Management

Both general partnerships and LLCs are managed by either the partners or the members, as the case may be, in the absence of a contrary agreement. Unless the power of a member, merely by virtue of being a member, is taken away by an appropriate statement in the operating agreement, members of an LLC act like partners in a general partnership, and have the power to bind the LLC in transactions with third parties.

Tax Aspects

1. Classification As A Partnership

Treatment as a partnership for federal income tax purposes is a key reason to form an LLC. In determining whether an LLC will be classified as a partnership, the Internal Revenue Service applies [Treasury Regulation § 301.7701-2](#), which sets forth the tests for determining whether an unincorporated business entity is classified for federal income tax purposes as a partnership or an association taxable as a corporation. This regulation identifies the following corporate characteristics: limited liability, continuity of life, free transferability of interest, and centralization of management.

If an unincorporated entity possesses three of these four corporate characteristics, it is classified as an association taxable as a corporation. Conversely, if an entity lacks two of the four corporate characteristics, it will be taxed as a partnership. Unless altered by the operating agreement, all LLCs formed under the New York Act will possess limited liability, but will lack all the other three characteristics, thereby permitting partnership classification.

**\*210 a. Limited Liability**

An entity possesses the corporate characteristic of limited liability if no member is personally liable under local law for the debts of, or claims against, the entity. In [Revenue Ruling 88-76](#) the LLC statute at issue (that of Wyoming) provided that neither the members nor the managers of an LLC were personally liable for a debt, obligation or liability of the LLC. Therefore, the Wyoming LLC possessed limited liability. Most state LLC statutes, including New York's Act,<sup>14</sup> contain a similar provision.

b. Continuity of Life

An entity lacks continuity of life if the entity is dissolved by the death, retirement, insanity, bankruptcy, expulsion, or some other event of withdrawal of a member, even though the remaining members may agree to continue the business. [Revenue Ruling 88-76](#) determined that the Wyoming LLCs did not possess the corporate characteristic of continuity of life because the Wyoming Act's provisions required an LLC to be dissolved upon the death, retirement, resignation, expulsion, bankruptcy, or dissolution of any member, or upon the occurrence of any other event that terminated the continued membership of a member in the LLC, unless the remaining members consented unanimously to continue the business of the LLC. New York's Act contains a similar provision, which can be modified by the members through the operating agreement.<sup>15</sup>

The New York Act permits the operating agreement to specify different dissolution-triggering events and a different level of vote (such as majority vote) to continue the business of the LLC upon the occurrence of an event of dissolution. The flexibility introduced by such a provision is not expected to prevent partnership classification. The Service has issued private letter rulings granting partnership classification to LLCs formed pursuant to other "flexible" state statutes<sup>16</sup>. In taking advantage of such flexibility, however, careful consideration should be taken to avoid creating the corporate characteristic of continuity of life.

c. Free Transferability of Interests

An entity possesses the corporate characteristic of free transferability of interests under [Treasury Regulation § 301.7701-2\(e\)](#) if a member has the power, without the consent of the other members, to substitute a non-member in his or her place, conferring all attributes **\*211** of ownership on that non-member. The Service ruled in [Revenue Ruling 88-76](#) that a Wyoming

LLC lacked free transferability of interests because the Wyoming Act provided that a member could not transfer the attributes of management and ownership in the LLC unless all of the other members approved the assignment.

The New York Act permits the members to provide in the operating agreement for different conditions relating to the transfer of interest.<sup>17</sup> For example, under certain circumstances, it might be more practical to provide for the transfer of a member's interest to be conditioned upon the majority consent of the members or upon the unanimous consent of the managers. There are indications that the Service will take the position that these more flexible solutions will not bar classification as a partnership.<sup>18</sup>

#### d. Centralization of Management

An entity possesses the corporate characteristic of centralization of management if a person, or group of persons, which does not include all of the members of the entity, is vested with the exclusive authority to make business decisions for the entity.

In New York, since the members are presumed to be agents of the LLC, the LLC should lack centralized management. Furthermore, this presumption, even if altered by the operating agreement, would still cause the LLC to lack the tax characteristic of centralized management because it would not be binding on third parties without knowledge of restrictions contained in the operating agreement.<sup>19</sup>

Interestingly enough, even if the presumption that all members are agents is removed by a statement in the articles of organization, the LLC may still lack the characteristic of centralized management if the members, rather than a group of representatives, manage the affairs of the LLC.

## 2. Comparison To S Corporations

From a tax standpoint, LLCs are quite similar to S Corporations because they offer all of their owners limited liability and also offer pass-through taxation treatment. LLCs, however, offer several advantages over S corporations.

In particular, LLCs are not subject to the restrictive and burdensome qualification requirements for S corporations. Once an LLC is organized in such a manner that it lacks a majority of the corporate \*213 characteristics, it is treated as a partnership for all federal income tax purposes. An LLC's tax treatment is not dependent upon filing an election with the Service.

S corporations cannot have more than thirty-five shareholders. In contrast, an LLC may have an unlimited number of members.

Although S corporations are not permitted to have shareholders that are corporations, non-resident aliens, general or limited partnerships, certain trusts, pensions plans, or charitable organizations, there is no similar restriction on the members of an LLC. The absence of these restrictions is probably the primary reason for the interest in the use of LLCs. The opportunity for investment by pension plans and domestic and foreign corporations in LLCs means that the LLC offers the combination of limited liability and flow-through taxation with the potential for future investment by pension plans or corporations without loss of pass-through taxation to the current owner, whereas S corporations cannot accept additional capital from such investors without converting to a different form of business.

While an S corporation cannot own more than eighty percent of the stock of another corporation and thus cannot be part of an affiliated group, no such limitation applies to LLCs.

Because an LLC, if properly formed, is classified as a partnership for federal tax purposes, the benefits of partnership tax treatment which do not accrue to S corporations are also available to LLCs. In particular, the one-class-of-stock rules would not apply to LLCs. Thus, the members of an LLC may take advantage of partnership special allocation rules pursuant to section 704(b) by structuring the allocation of profits, losses and distributions in differing ratios as among the members. They may also make use of the basis adjustment rules of section 754 in the event of a transfer of an interest in the LLC due to a sale of the interest or the death of a member.

An S corporation may be preferred over an LLC if the necessary restrictions on transferability of interest and continuity of

life are not practicable. If the business is to be closely-held, however, obtaining consent to transfer interests or to continue the business upon the occurrence of an event of dissolution may not be burdensome. In such case, the restrictions necessary to obtain partnership treatment for an LLC may be workable.

### 3. Comparison to Limited Partnerships

The distinctions in tax treatment between limited partnerships and LLCs are minor because LLCs are treated as partnerships for federal tax purposes. To the extent such differences exist at all, they \*214 are the result of the fact that a limited partnership has a general partner whereas an LLC has no general partner. For example, references to general partners or limited partners are contained in the Internal Revenue Code provisions relating to: the designation of a tax matters partner, material participation for purposes of passive/active distinctions, and use by syndicates of the cash method of accounting. The application of these provisions may vary depending upon whether managers of an LLC are analogized to general partners in a partnership.

#### Uses for LLCs

Practitioners are finding uses for LLCs in a wide variety of situations. Probably the most frequent impetus for their use results from an inability to use S corporations.

For example, LLCs are being viewed with interest by foreign investors who are prohibited from being shareholders in S corporations. In addition, LLCs are attractive to foreign investors because their structure is very similar to the structure of the GmbH, C.V. and Limitada.<sup>20</sup> Conversely, U.S. investors are also considering the use of LLCs for investment in foreign countries which should recognize the limited liability nature of the LLC.

LLCs could also be used in venture capital and joint venture transactions in which the investors want both flow-through tax treatment and the ability to control the operations of the business without interposition of a board of directors. LLCs can also be a useful acquisition vehicle in situations in which the purchasing entity would like to provide for differing distribution, management and voting rights as among the members.

An LLC is often considered when general or limited partnerships are not practical because no person or business is willing to assume the liability exposure of a general partner. Thus, LLCs are ideal for businesses such as real estate, oil and gas, high technology, research and development, entrepreneurial, start-up and family-owned business. Professional services firms (i.e., physicians, accountants and attorneys), have shown significant interest in using LLCs to combine limited liability with flow-through tax treatment. The New York Act allows professionals to conduct their practices through LLCs.

Because all fifty states have not yet enacted LLC legislation, the use of an LLC for a multistate business raises liability concerns. These concerns, however, are lessened if the LLC will be used (1) as a \*215 holding company, (2) for other passive investment that does not present substantial tort or product liability exposure, or (3) conducts business only within states which recognize LLCs. This limitation on the use of LLCs is likely to diminish rapidly, since it is expected that by the end of 1994 almost every state will have an LLC statute.

#### Footnotes

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<sup>1</sup> 1994 N.Y. Laws c. 576, to be codified at chapter 34 of the Consolidated Laws of New York in "Limited Liability Company Law".

<sup>2</sup> Forty-one states and the District of Columbia have enacted LLC statutes: Alabama, Arkansas, Arizona, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, West Virginia, Washington, Wisconsin,

and Wyoming. Furthermore, in every other state LLC legislation has either been introduced or will shortly be introduced.

<sup>3</sup> 88-76, [1988-2 C.B. 360](#).

<sup>4</sup> Ltd. Liab. Co. L. §203.

<sup>5</sup> Id.

<sup>6</sup> Ltd. Liab. Co. L. §417.

<sup>7</sup> See Ltd. Liab. Co. L. §603(b).

<sup>8</sup> Ltd. Liab. Co. L. §603.

<sup>9</sup> Ltd. Liab. Co. L. §401.

<sup>10</sup> Ltd. Liab. Co. L. §701.

<sup>11</sup> Ltd. Liab. Co. L. §1001.

<sup>12</sup> E.g., Ltd. Liab. Co. L. §801.

<sup>13</sup> But see [G.B.L. §130](#).

<sup>14</sup> Ltd. Liab. Co. L. §609.

<sup>15</sup> Ltd. Liab. Co. L. §701.

<sup>16</sup> E.g., [PLRs 9210019](#), [9219022](#) and [9226035](#).

<sup>17</sup> Ltd. Liab. Co. L. §603.

<sup>18</sup> [PLRs 9210019](#) and [9218078](#).

<sup>19</sup> [Treas. Reg. § 301.7701-2\(c\)\(4\)](#).

<sup>20</sup> Limited liability forms existing in Germany, the Netherlands and South and Central America, respectively.

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