Risk Concepts

Limited Liability Company

Historically, farms and ranches were operated as sole proprietorships. The land, machinery, livestock, and other assets were owned and used by an individual or couple. Likewise, the individual (or husband and wife) farmer/rancher was personally responsible for all debts and financial obligations owed by the business. The farmer or rancher was the business, and the business was the farmer or rancher.

There are a number of organizational structures that may better meet the needs of today's farm/ranch business. A few of the more common business entities used by farmers and ranchers include sole proprietorship, general partnership, limited partnership, limited liability company (LLC), and corporation. Each U.S. state recognizes most legal entities, while the U.S. Internal Revenue Code recognizes all business forms except LLCs. Each organizational structure has its strengths and weaknesses. Before a decision is made as to the legal entity under which to operate, a person – or person and his or her family and other partners – need to determine the goals of and needs for the business and its assets.

The Limited Liability Company (LLC) is a creature of statute, recognized in each jurisdiction only by virtue of a legislative enactment in each state. There are three aspects of the LLC that are enticing for new businesses: (1) it can be taxed as a partnership, as a corporation (if such an election is granted by the I.R.S.), or as a disregarded entity if there is only a single member; (2) it is an extremely flexible form of business both in terms of options when creating the business and options about how it is to operate; and (3) it offers all members limited liability.

Formation

An LLC is formed by filing an organizational document, often called "Articles of Organization," with the Secretary of State or other appropriate official. These articles perform a similar function and contain similar information to articles of incorporation or a certificate of limited partnership.

The articles of organization have certain requirements which depend on the statutes of the state in which the LLC is formed. One, the name of the LLC which may generally not be the same as or deceptively similar to the name of any other LLC, limited

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partnership, or corporation organized in or transacting business in the state where the LLC is to be formed or to a name that has previously been reserved by someone else. There is generally no limitation to the use of a member's name in the LLC. The name of an LLC must contain the words "Limited Liability Company" or "Limited Company" or the abbreviations for those terms.

A second requirement is the name and address of the LLC's registered agent – an individual who is a resident of that state or a business entity formed in the state, and is, in either case, authorized to accept service of process for the LLC. In most jurisdictions, the address given may be the agent's business, residence, or mailing address, but not a post office box. There must be an acknowledgement of the registered agent that he or she accepts the responsibilities of agent. Some states require that the acknowledgement and acceptance be included in the articles of organization, while other states allow a separate signed document.

Another typical requirement is that the articles include the address of the registered office of the LLC. In most states, the LLC is required to continuously maintain a registered office in the state that may, but need not, be the same as the place of business of the LLC. Because many statutes require certain minimal records to be kept at this office and available for inspection, most states require the address to include street and location rather than a post office box.

In some states, the articles must include other information such as the general purpose for which the LLC is to be formed or the latest date on which the LLC is to dissolve. Optional provisions are usually allowed as well, so long as they are not inconsistent with the requirements of the applicable statute.

The LLC statutes tend to include default rules on most of the issues that are likely to arise in the course of business operations. However, virtually all of these rules are subject to the contrary agreement of the members.

Most state statutes permit an LLC to accept contributions in the form of property, services rendered, a promissory note or other obligation to contribute cash or property, or to perform services in the future. Some statutes also require the members to agree to a value for all non-cash contributions and to keep a record of the value of each member's contributions. If, however, an LLC wanted to limit contributions, it could certainly do so. The requirement that the LLC keep a record of each member's contributions may or may not be subject to contrary agreement, depending on the state, but as a practical matter there is likely to be little reason to object to such a requirement.

Operational Attributes

Some state statutes require a written operating agreement. In most jurisdictions, however, an operating agreement is optional and is only required if the members wish to vary the default rules provided for in the state statutes.

Some state statutes presume that each member will have a vote equal to that of every other member, but most statutes allocate voting power in accordance with the relative value of each member's contribution to the LLC, unless the members have agreed otherwise. The statutes in all states allow the members to change how voting power is allocated, and such provisions are frequently included in operating agreements.

One issue related to voting power involves the type of matters which require either super-majority or unanimous agreement. There is significant variation among state statutes about what issues are presumed to require more than majority approval, although it is accurate to say that state statutes often presume that it will take a unanimous vote to do things that would fall outside the ordinary way of doing business. These might include a presumption that it will take unanimous agreement to amend the articles or the operating agreement of the LLC, to admit new or substitute members, to voluntarily dissolve the LLC, to merge or consolidate the LLC with another business entity, to sell all or substantially all of the LLC's assets, or to agree to continue the LLC despite what would ordinarily be an event of dissolution.

State statutes may also require unanimity to do things such as compromising an obligation by a member to make additional contributions, or settling disputes or agreeing to arbitration. After consulting the particular state statutes, it may be appropriate to make changes to the default rules concerning what types of actions would normally require unanimous approval.

LLCs may be managed by the members or by a manager. This choice must be decided when the LLC is formed, but the statutes in most states are member-managed by default.

Member-management means that all the members share responsibility for the day-to-day operations and have the power to bind the company to ordinary business contracts. This approach is more common in part because most LLCs are small businesses with limited resources and they don't need a separate management level to operate. Unlike corporations, LLCs have a streamlined organizational structure, without officers or boards of directors. As a result, the LLC form is often chosen by people who want to be directly involved in managing and operating their business.

In some situations, a manager-management structure may be preferable. Manager-management means that the managers will have both the actual power to manage and the apparent authority to bind the business by acts which appear to be carrying on the ordinary course of the LLC's business. The most common reason is that some members only want to be passive investors in the business. Two other situations where LLC owners may prefer a manager-management structure are: (1) when the business or ownership is too large, diverse, or complex to efficiently allow for sharing management among all members; or (2) when some members are not particularly skilled at management. The manager may be either a member or a nonmember.

Liability

Under the default rules of every state, members of an LLC have no personal liability solely because of their status as a member. They will, however, be liable for the amount or value of any agreed-upon contributions, for any debt they have guaranteed or for which they have otherwise agreed to act as surety, and for any personal misconduct in which they engage.

Members of an LLC are likely to have liability if the veil of limited liability is pierced. In such cases, the members act in a manner which is inconsistent with the recognition of the LLC as a separate entity (such as by commingling personal and business funds, failing to document loans to and from the entity, etc.).

Tax Attributes

LLCs that have two or more members will be presumed to be taxed as partnerships, but any given LLC may elect to be taxed as a corporation. Some state statutes impose a specific tax status on LLCs, regardless of how they might be classified for federal income tax purposes. Under federal law, LLCs having one member are taxed as sole proprietorships, unless an election to be taxed as a corporation is filed.

As with partners, members in an LLC are generally free to agree among themselves how they will share profits and losses. This agreement will normally control the amount of each member's share of taxable income or loss, so long as these allocations satisfy the "substantial economic effect" test. Assuming that test is met, the members may make special allocations of profits and losses in ratios different from their ordinary sharing ratios.

Distributions are generally based on cash flow rather than "profits" in either an economic or tax sense. Some operating agreements may contain an express formula for determining the amount of cash flow available for distribution. Other agreements will not contain specific formula provisions, assuming instead, as a general matter, that the LLC will not distribute what it does not have, and that those charged with managing the LLC should generally have discretion to declare distributions as they deem advisable.

Equally important to the determination of the amount available for distribution is when the distributions are to be made. Most state statutes say this will be as provided in the operating agreement or as the members in a member-managed or managers in a manager-managed LLC may decide. The most informal way of handling the timing issue is to say nothing about it in the operating agreement. Those in charge of management of the LLC, either members or managers, will decide when distributions will be made. On the other hand, the operating agreement may mandate that distributions be made when available cash flow permits.

Assuming an LLC is classified as a partnership, the LLC itself will not be subject to federal income tax, although an informational filing is required. For filing purposes, an LLC uses the same tax forms as a partnership. The current versions of these forms contain questions designed to elicit whether the filing entity is a general partnership, a limited partnership, or a limited liability company. These questions do not affect the filer's tax liability but are simply a means of collecting statistical information.

Generally, a member (as a tax partner) is only entitled to increase his or her basis in the amount of such member's "share" of the LLC's indebtedness. The regulations contain detailed rules describing the determination of the appropriate share of the debt for this purpose, and the results will vary depending on whether the debt is considered to be recourse or nonrecourse debt. The regulations distinguish recourse from nonrecourse debt on the basis of liability of the members. If no member bears the economic risk of loss, then the debt is nonrecourse debt. In an LLC, since no member has personal liability, presumably all debt would be nonrecourse under this standard, including debt that, from a commercial standpoint, would probably be viewed as recourse because the lenders have the right to look to the general assets of the enterprise to satisfy the debt.

The ability of individuals and certain closely held corporations to deduct losses of tax partnerships, and thus LLCs, is also limited by the "at-risk" rules. In general, members may deduct losses only to the extent that they are "at risk" with respect to the entity. For an LLC, the question is whether a members' obligations other than capital contributions will be considered an amount at risk since, as described above, the debt of an LLC will normally be nonrecourse. Although the law is less than clear, it appears that a member will be at risk for the share of LLC debt that the member guarantees.

The passive loss rules prohibit certain taxpayers from using net losses from passive activities to offset other taxable income. A "passive activity" is defined as any activity in which the taxpayer does not "materially participate." Taken together, the Internal Revenue Code and Treasury regulations set out a system of rules pursuant to which it is possible to determine when a partner is deemed to materially participate in the operation of a business. Further, the I.R.S. generally treats a member's share of LLC income as self-employment income, unless the membership of the LLC is set up so that all income funnels through another entity, such as an S corporation.

Transfers of Ownership (Succession and Estate Planning)

In most states, the LLC statutory provisions on transferability of ownership interests have been modeled after the Uniform Partnership Act (UPA), and provide that a transfer of an LLC membership interest operates only to transfer the economic rights, unless the remaining members unanimously agree to accept the transferee as a substitute member. They may provide in advance that a membership interest is freely transferable and that any transferees will automatically be accepted as members of the LLC by the simple expedient of a provision to that effect in the operating agreement. Alternatively, they may provide that a limited class of persons (such as immediate family members or employees) will be entitled to full membership upon the acquisition of any membership interest.

Alternatively, the members could condition transferability by imposing transfer restrictions upon membership interests. The operating agreement could require a member to first offer any membership interests to existing members, or to the LLC itself, and only if these offers are rejected would a sale to a third person be recognized as entitling the transferee to membership status. The purchase rights accorded to the existing members could be structured as an option or as a right of first refusal. Such provisions are especially common in the corporate

context, but where it is desirable to provide transferability of interests in order to entice additional investors into contributing to the capital funds of an LLC, such provisions may also be appropriate in this setting. The operating agreement might also be drafted to further restrict the transferability of membership interests, thereby limiting the ability of members to transfer even the economic rights of ownership.

Dissolution

The right of members to withdraw, and the consequences of such withdrawal, are issues that probably should be specifically considered and agreed upon in advance. If members do have the ability to withdraw, notice requirements and any obligation on the part of the LLC to pay for the value of the withdrawing member's interest should probably be spelled out in the operating agreement.

The rights of a member to withdraw from an LLC may also be an issue in some cases. In some states, members generally have the ability to withdraw, but only if the operating agreement does not provide otherwise. If the operating agreement does restrict withdrawal rights, the member cannot simply quit.

When most state LLC statutes were originally drafted, there were tax incentives in place to make the LLC look as much like a general partnership as possible. Thus, virtually all of the original LLC statutes provided that members in a LLC had the ability to withdraw at any time, even in contravention of a provision in the operating agreement prohibiting such withdrawal.

From the point of view of the LLC, it may be extremely inconvenient to have a member withdraw at certain points in time. The LLC may wish to avoid having to calculate value of a member's interests as of certain points in time, or may fear that there will be significant but unprovable costs associated with withdrawal in violation of a contractual obligation to remain with the company that can best be resolved by a prohibition on voluntary withdrawal.

The events that trigger dissolution in the absence of an agreement are often very similar to the events that trigger dissolution of a general partnership, although a growing number of states seem to be reducing the number of events that automatically trigger dissolution. The statutes often list things like withdrawal, bankruptcy, incapacity or death of a member; agreement of all members; expiration of a stated term or completion of a specific undertaking; or anything specified in the operating agreement as constituting an event triggering dissolution. Some state statutes have been amended to narrow the list of things triggering dissolution, and every state statute allows the members to either subtract from or add to this list.

In addition, most LLC statutes have default rules governing the right of members to waive an event as a trigger for dissolution, and the members have the further right to provide in the operating agreement that any number of remaining members at the time of any such event will have the power to continue the business.

The LLC statutes generally contain provisions for judicial dissolution, with considerable variation as to what constitutes sufficient grounds for a court to order. Often this statute is very general, providing only that the court may order dissolution whenever it is not reasonably practicable to carry on the business of the LLC in conformity with the operating agreement or for any other equitable reason.

Once dissolution is triggered, most LLC statutes appear to follow the corporate model governing the winding up and termination of the business. There are provisions for the filing of articles of dissolution, giving of notice to known and contingent creditors, and covering the distribution of assets and the possibility that creditors might later come after members for any amounts received as liquidating distributions.

In the case of liquidating distributions by an LLC, most state statutes protect the rights of creditors by giving them a higher claim to the LLC assets than members have and generally providing that their claims will not be discharged before they are notified (actually or constructively) and given an opportunity to present their claims to the LLC. In most cases, however, no express limitations are placed on interim (nonliquidating) distributions made by the LLC to its members.

Summary

The Limited Liability Company (LLC) is a creature of statute, recognized in each jurisdiction only by virtue of a legislative enactment in each state. There are three aspects of the LLC that are enticing for new businesses: (1) it can be taxed as a partnership, as a corporation (if such an election is granted by the I.R.S.), or as a disregarded entity if there is only a single member; (2) it is an extremely flexible form of business both in terms of options when creating the business and options about how it is to operate; and (3) it offers all members limited liability.

A person wanting to start a business should first determine his or her risk preferences and both short and long term goals; second, seek appropriate professional counsel from an attorney, accountant, and others; and finally, establish the business.

Resources

Part I: An Overview of Organizational and Ownership Options Available to Agricultural Enterprises. Goforth, Carol R. An Agricultural Law Research Article. National Agricultural Law Center. July 2002.
Part II: An Overview of Organizational and Ownership Options Available to Agricultural Enterprises. Goforth, Carol R. An Agricultural Law Research Article. National Agricultural Law Center. July 2002.
Fact Sheets from the Internal Revenue Service and Secretary of State office in various states.

The information presented in this document is intended for educational purposes only. It should not be construed as providing legal, accounting, or other professional advice. People considering the establishment of a business enterprise should seek appropriate professional assistance.