A Practitioner's Guide to Limited Liability Companies

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The age of the limited liability company (LLC) is now upon us. They are being formed by everyone: lawyers, accountants, financial planners, insurance agents and clients themselves. The purpose of this writing is to discuss the shortfalls left by those uninformed entity creators. These shortfalls are numerous and dangerous to the legal health of the entity. The CPA has the best view of how the LLC is managed, and thus an integral part of maintaining its existence.

This onslaught of LLCs formed without operating agreements has brought forth many member disputes. The most common is where the members have orally agreed to share profits and distributions disproportionately. The first Florida Limited Liability Company Act, Chapter 608, Florida (the Act) provides that the members are equal unless otherwise agreed.

The Act was enacted in 1982 and substantially modified in 1993. Florida's LLCs were little used because the State imposed the corporate income tax on LLCs. The tax on LLCs was repealed in 1999. The Act has been revised several times since then, including a major overhaul effective January 2, 2013.[1] A "glitch" bill was enacted in 2015 to clean up a number of provisions.

The Act is basically a default statute. That is, it is the answer unless the members agree otherwise. The best way to provide for the governance of an LLC is to prepare a detailed operating agreement (the "O/A") setting forth as much custom drafting provisions as appropriate. However, the Act lists several items that may <u>not</u> be contained in the O/A.[2] An LLC may not:

- vary an LLC's capacity to sue or be sued
- vary governing law outside of Florida
- vary procedures regarding registered agents or state filings
- eliminate the duties of loyalty or care (with some exceptions)
- eliminate the obligation of good faith and fair dealing
- relieve a person from liability for conduct involving bad faith, willful or intentional misconduct or a knowing violation of law
- vary the power of a person to disassociate
- vary the grounds for dissolution or to wind up the company
- unreasonably restrict the right of a member to maintain an action against another member, the manager or the company
- vary the right of a member to approve a member, interest exchange, conversion or domestication

The LLC must maintain the following records at its principal place of business:[3]

- a full current list of names and addresses of each member and manager
- copy of the O/A, including all amendments thereto
- copy of the articles of organization, merger, interest exchange, conversion and domestication, and all amendments, together with executed copies of any powers of attorney
- copies of the company's federal, state and local tax returns
- copies of the company's three most recent financial statements
- record of cash and property contributed by each member

Failure to attend to the "formalities" can subject the LLC to a "piercing" of the entity veil, permitting the LLC's creditors to look up to the members for personal liability against LLC debts, and "reverse piercing" permitting a member's creditor to attach the assets of the LLC. There have been many piercing cases relating to LLCs recently, much more so than corporate piercings.[4]

In addition to the formalities set forth above, the courts have looked to several elements, none of which are sufficient unto itself to cause piercing of an LLC. They are:

- failure to observe "corporate" formalities (although LLC formalities are intended to be less burdensome than those for corporations)
- inadequacy of capital (some cases have held creditors to a higher standard because they are able to inspect the financial statements of an entity and discover potential risks of loss before any transaction takes place)[5]
- diversion of assets from the company for personal use
- payment of personal expenses out of LLC funds
- failure to maintain arm's-length relationships among related parties
- co-mingling of funds, assets and employees
- non-payment of dividends, especially in reverse piercing or "alter-ego" cases
- non-functioning management (an LLC whose O/A calls for members to participate in management should be treated differently from an LLC whose members elect managers)
- fraud or injustice – needed in Florida (except alter ego cases)
- Many courts have taken the position that the corporate piercing criteria should be applied to LLCs as well. However, some commentators believe that a more liberal approach to the application of these rules to LLCs.[6] ➡

Care should be taken when converting to and from an LLC. It is a simple form to be filed with the Florida Secretary of State,[7] but the tax implications can be daunting. The conversion of an LLC to a corporation is generally not taxable. However, the converse is taxable. A conversion of a corporation to an LLC is treated as if the corporation in complete liquidation distributed the assets to its shareholders, who then contribute them to the LLC. This "deemed sale" is a taxable event.

Series LLCs

1. The Series LLC is a separate legal entity like a normal LLC, but it also has the ability to partition its assets, debts and other liabilities among two or more distinct "series" or "cells" (Series) under the umbrella of a "master" LLC. A Series is like a division for maintaining assets and liabilities separate from the assets and liabilities held within other Series of the Series LLC. While Series LLCs are particularly useful for segregating investment shares and apportioning the return or cash flow from several assets or portfolios held by a single entity, this alternate structure has many other applications, particularly when fractionalized ownership would foster liability management and asset protection (for example, separating parcels or components in a real estate development), or dividing economic participation among several businesses or investments that are partially but not wholly-owned in common (such as a manger-sponsor who wishes to market a process or concept in several locations and needs either local capital or services).

2. Series LLCs were first enacted in the State of Delaware in 1996. Other states that have adopted Series LLCs include Illinois, Iowa, Nevada, Oklahoma, Tennessee, Texas and Utah. A Series LLC is an entity that permits the creation of separation series, wherein the assets of one Series are shielded from the liability of another series without having to actually form a separate legal entity.

3. In Florida and the remainder of the states who have not adopted Series LLC, the same result can be accomplished by forming subsidiary LLCs. The key administrative cost differential appears to be that the Series LLC saves in the formation cost of each subsidiary, filing fees, professional fees, and annual renewal fees.

4. Case law has not been developed on Series LLCs yet, and there is much fear in the professional world that the assets may not be as protected as when the entity is formed. What is clear is that the "corporate formalities" must be carefully followed, such that:

a. Separate books and records should be maintained for each series

b. Creditors need to be made specifically aware of the separate existence of each series

c. The assets of each must be unambiguously identified as belonging to that series

5. One of the most significant issues is whether bankruptcy courts and creditors will be bound by the limited liability standards that would otherwise apply to the Series LLCs by the terms of their organizational statutes, and whether their internal shields will be recognized in states that do not have Series LLC enabling provisions. It is not clear whether a Florida court will uphold liability protection if an out-of-state Series LLC decides to conduct business within Florida. The Florida Department of State is trying to determine the best course of action for allowing out-of-state Series LLCs to register as a foreign LLC doing business in the state. While the Full Faith and Credit Clause of the U.S. constitution requires states to respect transactions governed by the law of another state, the breadth of this protection is limited when the law is against the host state's public policy. There is still some uncertainty as to how bankruptcy courts will treat the separate Series of a Series LLC under its "consolidation" rules.

6. It is still not entirely clear how a Series will be characterized for federal and state income tax purposes. In 2008, the IRS issued the first Private Letter Ruling (PLR 200803004) upholding implicitly that each Series of a Series LLC is a separate entity for federal tax purposes. The ruling was issued to a group of insurance companies that were reorganizing their mutual fund as a Delaware Series LLC, and affirmed that each Series was entitled to choose its own entity classification independent of the classification of the other Series. While the IRS did not explicitly rule that each Series of the Series LLC is a separate legal entity, the ruling treated each Series as being entitled to elect its classification under the check-the-box regulations. Moreover, the IRS allowed multiple

entity classifications for the Series within the same Series LLC, which would not be possible unless each Series was treated as a separate entity for classification purposes under the IRC § 7701 regulations. In other words, the IRS ruled that a Series with one member would be treated as a disregarded entity, while the Series with more than one member could elect to be treated as either a partnership or as an association taxable as a corporation.

7. Where the entity is properly set up and the operative documents reflect clearly the series, each LLC in the series with one member should be disregarded for federal income tax purposes. However, there have been analogous cases in the trust area that have held such subsidiaries as separate taxpayers. This may be of particular importance where the ownership percentage is different on a series-by-series basis.

8. Some Uses for a Series LLC:

a. Cell for Captive Insurance Companies, where separate participants utilize the same license insuring company for their individual benefit

b. Large retail chains with a vast number of business sites, such as fast food restaurants and gas stations

c. A real estate investor with a large number of properties

d. Mutual funds

Single Member LLCs

A single member LLC is an LLC with only one member. There is a surprising amount of misunderstanding about the structure of a single member LLC. Some of this stems from the fact that the original LLC Act required at least two members, similar to the Partnership Acts. When the Act was modified to permit only one member, other provisions of the Act were not corrected, such as the charging order provisions. A single member LLC is an entity (i) which is governed by an LLC statute (as opposed to a corporate statute), (ii) which offers the sole owner the ability to limit his or her responsibility for debts and obligations to the amount of equity committed to the entity, and (iii) which is ignored as a separate entity for federal income tax purposes unless it elects to be treated as a corporation under the check-the-box regulations. A single member LLC should have an operating agreement.

Tenancy by the Entirety as a Single Member LLC

Reason to use:

(1) Charging Lien Protection

(2) Florida Asset Protection Laws

Under partnership tax law, the issue is whether a husband and wife may be treated as one partner/member, regardless of whether they own their interest separately or through some form of joint ownership. The IRS has not provided guidance as to whether a single member LLC owned by a husband and wife as tenants by the entireties is a disregarded entity or partnership for federal income tax purposes. Is there a difference from a tax perspective? Has anyone had a client receive a notice from the IRS requesting a partnership return? *See* Rev. Proc. 2002-69 (2002-2) where the Service ruled that in a community property state, a husband and wife are considered one owner of an LLC and, hence, the LLC would be disregarded. FCT

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Endnotes

[1] Florida Statutes, Chapter 605
[2] Florida Statutes, Section 605.105(3)
[3] Florida Statutes, Section 605.410
[4] *Greenhunter Energy, Inc. v Western Ecosystems Technology, Inc.* (2014 WY 114); *Wells Fargo Bank, N.A. v. Barber*, F. Supp 3d (2015); *Litchfield Asset Management Corp. v. Howell*, 799 A 2d 298 (Conn. 2001); *Klein v. Weidner*, 2014 WL 47,800 (E.D., PA); *Postal Instant Express, Inc. v. Kaswa Corp.*, 162 Cal. App, 42 1510 (Cal. Ct. App 2000); *In Re Albright*, 291 B.R. 538 (Bankr. 2003); *In Re Ehmann*, 319 Bankr. D. Ariz. 2005; *In Re Modanlo*, 412 B.R. 715 (Bankr. D. Md 2006); *In Re A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. Idaho 2006); *Olmstead, et al. v. FTC*, 44 So. 3d 76 (Fla. 2010)
[5] *Co-Ex Plastics, Inc. v. Alapak, Inc.*, 536 So. 2d 37 (Ala. 1988); *Kinney Shoe Corp. v. Polan*, 939 F.2d 209 (4th DCA 1991)
[6] *See Eric Fox*, Piercing the Veil of Limited Liability Companies, George Washington Law Review (1994)
[7] Florida Statutes, Section 605.1041-1046