

# Essay on limited liability companies

[Business](#), [Company](#)



## **Introduction**

The first limited liability company (LLC) in the United States was established in Wyoming in 1977, and the next one was established in Florida in 1982; but it wasn't until 1996 that the National Conference of Commissioners on Uniform State Laws adopted the Uniform Limited Liability Company Act (ULLCA) (Uniform Law Commission, 2012).

A LLC is a flexible type of hybrid business ownership that combines the limited liability of a corporation with the tax benefits of a partnership. LLC's are owned by members, not partners or shareholders, and may be composed of any number individuals, corporations, other LLC's, or foreign entities (Kleinberger, 2004).

There are several advantages to an LLC. Members of a LCC cannot be held personally liable for the debts or acts of the LLC unless they have signed a contract personally assuming liability. Another advantage of a LLC is that members have a great degree of flexibility as to how to divide profits; and, in fact, there is not even a need for a LLC to be a profit-making enterprise. Day-to-day management is also simpler as members are not required to keep formal records of their meetings nor are members required to keep their corporate and individual taxes separate and thus get to enjoy the benefits of pass-through taxation (Kleinberger, 2004).

However, there are some disadvantages to a LLC. LLCs do not live forever in the manner of corporations, instead they are dissolved when one of the members either dies or files for bankruptcy. In addition, a LLC cannot go public or issue shares to its members. It is also more complex to handle taxes because the IRS has different LLC classifications for tax purposes. The

federal government does not recognize an LLC as a classification for federal tax purposes, which means that a LLC has to file taxes as a corporation, partnership, or sole proprietorship. However, it is easier to establish a LLC than it is to establish a corporation; for example, it takes around 5 minutes to establish a LLC online.

Each state has its own set of rules governing the establishment of a LLC although most states follow the Uniform Limited Liability Company Act (ULLCA) (Uniform Law Commission, 2012). The first step in establishing a LLC under the ULLCA is to choose a name that indicates that the business being formed is a LLC. You then need to file articles of organization, usually with the Secretary of State or other such state department, and this is simply a document to legitimize the business and list all the members. It is also recommended to draft an operating agreement, which defines the benefits and responsibilities of each of the members of the LLC. Depending on the type of business, licenses and business permits may also be required. In addition, some states require that you publish a statement in the local newspaper announcing the establishment of the LLC ) (Uniform Law Commission, 2012).

In 2006, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved and recommended nation-wide enactment of the Revised Uniform Limited Liability Company Act (Re-ULLCA) (Kleinberger, 2004). Under the Re-ULLCA, the term “ articles of organization” was changed to “ certificate of organization” to indicate that this document is just to establish the existence of an LCC rather a set of governing rules for the business and its owners. It is not to be confused with the “ articles of

incorporation,” which does detail the rules of governance. The Re-ULLCA has a very broad definition of “operating agreement;” as soon as a LLC has any members, an operating agreement is automatically considered to be in place; that is, there is no need for the operating agreement to be in writing, a verbal or implied operating agreement satisfies the Re-ULLCA. There are many issues that can come under an operating agreement, and the Re-ULLCA uses three sections to address the various issues. Section 110 defines the scope and general power of the operating agreement as well as its limitations. Section 111 deals with the process of the operating agreement and Section 112 deals with the effect of the operating agreement on other parties and the LLC itself ) (Uniform Law Commission, 2012).

One of the most important roles of the Re-ULLCA is to codify the fiduciary duties of the LLC members and define the limitations of liability. In essence, a member of a LLC owes to the company and other members the fiduciary duties of loyalty and care; members must also conduct their operations under the contract law concept of good faith and fair dealing. However, a member does not violate a fiduciary duty under the LLC agreement merely because the member’s conduct furthers the member’s own interest; nevertheless, a member is prevented from harming the company, or competing with the company in the conduct of the LLC’s activities. The member has to account to other members for any property, profit, or benefit that the member derives from the LLC. (Kleinberger, 2004). A member owes a reasonable duty of care that a person in a similar circumstance would exercise and in a manner the member reasonably believes to be in the best interests of the LLC. This standard of care is higher than in a limited

partnership where the partners need only refrain from grossly negligent or reckless conduct, intentional misconduct, or intentional violation of the law. However, the ordinary standard required by the Re-ULLCA is subject to the business judgment rule under certain circumstances ) (Uniform Law Commission, 2012).

Section 301 of the Re-ULLCA also has provisions for the legal binding of the LLC by a member to a third party under a concept called ‘ statutory apparent authority.’ However, this differs depending on whether the LLC is a member-managed or manager-managed LLC. If the LLC is manager-managed, a member does not have the power to bind the LLC to a third party. Section 301 states that given the circumstances other law may hold a member liable either directly or vicariously by the conduct of another member. Thus, LLC’s are not necessarily subject to statutory apparent authority because other law can determine liability. Other law includes the contract law of agency or course of dealing and the tort law of respondeat superior. These issues tend to arise more often by the conduct of a member in a manager-managed LLC. Statutory apparent authority is so complex that Section 302 of the Re-ULLCA provides that a LLC may state in writing which of the members have authority with respect to property rights or the bidding of the LLC to third parties. In the matter of real property, Section 302 requires double filing of documents related to the transaction where proper filing and recording of documents is necessary. This serves to protect both the LLC and third parties (Uniform Law Commission, 2012)

Because of the confusion to third parties regarding the two types of management, most LLC statutes have a set of default rules covering the two

types of management, provided as a sort of templates. Members of the LLC may either rely on the templates or write their own rules under the operations agreement .

## **Advantages**

There are other advantages of forming a LLC aside from the limited liability of a corporation and pass-through taxes of a partnership. A LLC has all the benefits of a corporation without some of its drawbacks, such as the annoyances of double taxation and excessive documentation. Double taxation means that taxes are paid both by the corporation and the individual. The LLC avoids this because the LLC itself does not have to file a tax return. Profits or losses of the LLC are declared in the owner's own Form 1040 personal income tax returns. If the LLC has only one owner, the taxes are as for a sole proprietorship. Members get their money either through a share of the profits or through guaranteed payment. LLC profits are not considered to be earned income by the members so they do not have to pay self-employment taxes, except for the managing member who are considered inactive members. This allows managing members to deduct from their taxes 100% of the health insurance premiums they pay. On the other hand, guaranteed payments are considered earned income, which means the members can enjoy tax-related fringe benefits. Members can write themselves checks but they cannot pay themselves wages.

Corporations can become members of an LLC in order to enjoy benefits not available to corporation and in addition get an extra level of protection against liability (Kleinberger, 2007).

Another advantage to a LLC is that it can be set up with just one natural person as a member or with an entity that becomes the owner. A one person LLC is taxed just like a sole-proprietorship enterprise but it has the protection against liability and permanence of a separate entity and all the other benefits of a LLC. The one person LLC can grow to as more members as the situation calls and there is no restriction to the number of members in a LLC (Kleinberger, 2004).

In general, state LLC Acts do not require that the members hold any general meetings, nor is there a board of directors and thus no dilution of power although some operation agreements make provisions for centralized management with powers similar to those of a board of directors. There is also very little administrative paperwork and recordkeeping required. One very important feature of the LLC is that members can assign their LLC interests and the profits from the LLC can be separated and assigned, granting the assignee the economic benefits of the LLC without entitlement to membership (Kleinberger, 2004).

One important feature of a LLC is that adding the “ LLC” at the end of the business entity name lends credibility to the business and also indicates that the entity is registered at the state and not just the city or county level. Also, if you plan to pass down your family business down to the next generation some day setting up your business as a LLC can help smooth the transition . A member of a LLC is also free to place the LLC’s interest into a living trust for their beneficiaries. By contrast, it is very difficult for a member of a

corporation to place the shares of the corporation into a living trust (Kleinberger, 2007)

LLC's also have more options when raising money, such as admitting new members by selling memberships interests; an LLC can also create new classes of membership interests with different rights or profit allocations. Another financial advantage of a LLC is that LLC members do not have to pay unemployment insurance taxes on the money they get from the LLC, although they have to pay self-employment taxes on any money they get from the LLC .

## **Disadvantages**

One of the disadvantages of a LLC comes when it comes to raising money because investors do not feel as comfortable with a LCC as they do with a corporation, and for this reason people in business prefer to set up corporations. Corporations communicate permanence, carry prestige and credibility, and are easier to establish credit with .

It is also easier to deal with corporations than with LLC because there are many boilerplate agreements available for corporations but few such agreements for LLC's. This means that legal fees can be higher when doing business with an LLC because lawyers have to spend a lot of time drafting agreements. However, this is bound to change as the number of LLCs increases and they too accumulate their own collection of boilerplate agreements. Another disadvantage of a LLC is that while a corporation is able to take tax deductions on many of its expenses including entertainment and travel expenses a LLC does not have these benefits. In addition, pension



or retirement plans can grow more effectively within the system of a corporation (Kleinberger, 2007).

Even though LLC's can protect you from personally liability, this protection is not ironclad. A member may be liable for the debts of a LLC if the member personally guarantees a debt, the member intermingles personal with LLC funds, or if the LLC violates a state law.

Another advantage of a corporation over a LLC is that even though the owner of a company might have bad personal credit the owner can still structure the corporation in such a way that the company can have a good credit profile, allowing the owner to borrow money, establish lines of credit, get issued credit cards that the owner would not be able to get directly as an individual. On the other hand, creditor can reach the assets of a member of a LLC .

Another issue with LLC's is that LLC's cannot be modified as easily as a corporation because you cannot amend the operation agreement as you can the Articles of Incorporation.

However, because of their easy management and beneficial taxation structure LLC's are becoming more and more popular and have surpassed the corporation as the business entity of choice for many wishing to establish a small business.

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