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## **LIMITED LIABILITY COMPANIES**

### **I. INTRODUCTION AND BACKGROUND**

The limited liability company (referred to as LLCs) combines the advantages of a corporation with the advantages of a partnership. A properly formed LLC can possess both the limited liability of a corporation and the pass-through tax treatment of a partnership. The availability of the LLC effectively eliminates the traditional "Hobson's choice" that business planners have had to make between possessing limited liability and possessing the pass-through tax treatment of a partnership. Although the LLC is a relatively new form of business organization in the U.S., it embodies corporate, partnership and tax concepts that are familiar to U.S. attorneys. All fifty states and the District of Columbia have enacted LLC statutes.

While the LLC is a new form of business organization in the United States, it has existed in Europe and South America since the 19th century. The designation "GmbH" after a company name identifies a German LLC. The designation "S.A.R.L." identifies a French LLC and the designation "E.P.E." identifies a Greek LLC. In South America, an LLC is referred to as a "Limitada".

As compelling as the LLC may appear, it should not be construed as the "right" form of business organization for all businesses under all circumstances. One should consider the LLC as one more available form of business organization along with C corporations, statutory close corporations, S corporations, general partnerships, limited partnerships, limited liability partnerships and sole proprietorships. Every form of business organization, including the LLC, has advantages and disadvantages. The relative significance of these advantages and disadvantages will vary considerably depending on the business objectives and plans of the client. Consequently, the LLC does not eliminate the need to systematically analyze each available form of business organization with reference to the particular business objectives and plans of the client before choosing a form of business organization.

### **II. TERMS AND DEFINITION OF AN LLC**

**Terminology:** Like corporations and partnerships, LLCs have a terminology that is specific to LLCs:

"Member" means a person who owns an interest in the LLC and is the functional equivalent of a "partner" or a "shareholder".

"Manager" means a person hired by the LLC to manage or operate the business of the LLC. A manager can be, but need not be, a Member.

"Articles of Organization" is the document that identifies the LLC and is filed with the government authority like articles of incorporation. The filing of the articles of organization commences the legal existence of the LLC. They are the functional equivalent of articles of incorporation and a certificate of limited partnership.

"Operating Agreement" is the contract made by the members that governs the relationship between the members and the LLC and the relationship among the members. Serving the same purpose as the partnership agreement or the shareholder agreement, the operating agreement orders the affairs of the LLC and the manner in which the business will be conducted.

"Membership Interest" means the percentage of the LLC interests owned by a Member at any particular time. All benefits, liabilities and obligations contemplated by the Members will flow to the Members in accordance with their respective Membership Interests. A Membership Interest is the functional equivalent of ownership interests in a partnership and shares of a corporation. A Membership Interest consists of governance rights financial rights and management rights.

### **Definition of an LLC**

An LLC is a creation of statute. An LLC can be formed and exist as a matter of law only if a state statute enables the creation of LLCs. Unlike a partnership, an LLC can neither be implied at law nor exist by estoppel. An LLC is an entity that is an unincorporated association and that has a duration that is not perpetual. In most states, an LLC can be formed by one organizer but it must have two or more members. The California statute allows for the formation of single member LLCs. A member can be a natural person, a corporation, a partnership or another LLC.

If the proper election has been made, the LLC will be classified as a partnership and not subject to corporate income tax for both federal and state income tax purposes. An LLC can be formed for any business purpose as long as the purpose is a lawful one. The members may limit the powers of the LLC or restrict how the powers are exercised as long as the limit or restriction is contained in the articles of organization. If no such limit or restriction is contained in the articles of organization, then the LLC may possess and exercise all powers that are necessary or convenient to carry out the business purpose of the LLC.

The LLC may acquire and hold property in the name of the LLC rather than in the names of the members. Also, an LLC can sue or be sued in its own name. A member can sue the LLC in a derivative action to the same extent and under the same conditions that a shareholder can sue a corporation.

### **Comparison with Other Forms of Business Organization**

A review of the primary attributes of other forms of business organization is useful to understand the nature of LLCs:

**Corporation:** The shareholders have limited liability but the corporation is taxable at the entity-level. The shareholders must comply with corporate formalities such as annual meetings, minutes and resolutions, by-laws and elections of boards and officers. A corporation does not dissolve upon the dissociation of a shareholder.

**Statutory Close Corporation:** The shareholders have limited liability but the corporation is taxable at the entity level. The shareholders can dispense with corporate formalities and operate with only a shareholder

agreement. The number of shareholders is limited usually to 35 and cannot make a public offering of its shares. The corporation does not dissolve upon the dissociation of a shareholder.

***S Chapter Corporation:*** The shareholders have limited liability and the S election enables the corporation to be taxed in a manner similar to pass through entities. The number of shareholders is limited to 35 and all of them must be U.S. citizens or permanent residents. The S corporation can have only one class of shares. The corporation does not dissolve upon the dissociation of a shareholder.

***General Partnership:*** The partners lack limited liability. The partnership is taxed as a pass through entity. There are no entity formalities and the partners can operate with only a partnership agreement. The partnership dissolves upon the dissociation of a partner unless there are two or more remaining partners who agree to continue.

***Limited Partnership:*** At least one partner must be a general partner who lacks limited liability. The liability of the other partners is limited to the amount of their contributions to the partnership. It is taxed as a pass through entity. The partnership dissolves upon the dissociation of the general partner unless there are two or more remaining limited partners agree to continue with a new general partner.

***Sole Proprietorship:*** The proprietor has no limited liability and is taxed as an individual. There are no prescribed formalities for organizing and maintaining a sole proprietorship.

### **Conversion of a Partnership into an LLC**

Partnerships can be converted into LLCs and the LLC will be treated as a continuation of the partnership so that no transfer of assets or interests occurs.

### **Professional Service LLCs Not Authorized**

Licensed professionals and those who are required to be licensed under the California Business and Professions Code are not authorized to organize as LLCs and render services as LLCs. Moreover, professionals cannot limit their personal liability for acts or omissions of malpractice. The LLC statutes expressly exclude from the limited liability afforded to members liability arising from acts or omissions of malpractice so that the professional would be personally liable for any judgment rendered on a cause of action for malpractice.

### **Organizing Principles of LLC Statutes**

LLC statutes are essentially enabling legislation as opposed to regulatory or administrative legislation. They contain mandatory provisions and default provisions. Mandatory provisions contain rules or requirements with which the members must comply in order for the LLC to be a legally created and operated business entity. Mandatory provisions almost always contain the connector "shall" or "must" in the language of the provision. Default provisions contain rules or requirements that will govern the conduct of the members or the affairs of the LLC if the members have not made an agreement with respect to matters covered by the default provisions. Default provisions usually contain the clause "unless otherwise agreed by the members" or "in the absence of agreement by the members". To avoid the legal effect of a default provision and to assure that the particular agreement by the members shall control on a particular issue, that agreement must be in writing and contained in either the articles of organization or the operating agreement. An oral agreement on a particular issue shall not be enforced and, regardless of the intent of members, the default provision on that issue will govern.

The LLC statutes are designed to afford the members as much flexibility and discretion as possible in governing the LLC and managing the business of the LLC. To this end, the Act minimizes the number of mandatory provisions and maximizes the number the default provisions. The substantive legal concepts embodied in both the mandatory and default provisions of LLC statutes are drawn from the laws governing general partnerships, limited partnerships and corporations.

### **III. ARTICLES OF ORGANIZATION, LLC RECORDS AND MEMBER RELATIONS**

#### **Articles of Organization**

The articles of organization under the area statutes require a minimal amount of information. The existence of the LLC commences when the articles are filed.

#### **Maintenance of LLC Records**

Each LLC is required to create and maintain certain basic information and records at its principal office. Each member has the right, upon reasonable request, to inspect the information and copy any records. The required information and records include the names and identifying information of each member, copies of the articles of organization as they may be amended and the certificate of organization as it may be amended, copies of all local, state and federal tax returns and reports for the 3 most recent years and copies of any operating agreement. If not contained in the operating agreement, the LLC must maintain a description in writing of the contribution of each member, the times, if any, at which additional contributions must be made, any right of a member to receive or of the LLC to make a return of contribution and any event the occurrence of which will cause the LLC to dissolve and the winding up of the business of the LLC.

The failure of the LLC to create and maintain the required information and records will not cause the LLC to lose its status as a limited liability company. An aggrieved member could seek and most likely obtain injunctive relief against the LLC for failure to maintain the required information and records.

#### **Member Relations**

Similar to corporation statutes but unlike partnership statutes, most LLC statutes do not mandate that fiduciary duties exist between and among members. The members should affirmatively specify the fiduciary duties that they desire in the Operating Agreement. The commonly recognized fiduciary duties are:

- Duty of Loyalty
- Duty of Care
- Duty to Act in Good Faith
- Duty to Refrain from Self Dealing
- Duty Not to Compete with LLC or Not to Usurp an LLC Opportunity
- Duty to Use LLC Property or Assets only for the Benefit of the LLC

### **IV. FUNDAMENTAL CHANGE TO THE LLC**

The issues of assignment of membership interests, admission of new members, dissolution and continuance of the LLC cause the LLC to undergo a fundamental change because they alter the legal relationship between and among the members and the LLC that existed when the LLC was formed. Because these issues are deemed vital to the efficacy and efficiency of the LLC as a form of business

organization, the LLC statutes are designed to provide the members with maximum flexibility to arrange these issues as they see fit. Before the self-classification regulations became final (see Part V, *infra.*), the members had to assure that they did not organize the LLC to possess a preponderance of the corporate attributes if they sought to have the LLC classified as a partnership for tax purposes. With the enactment of the self-classification regulations, the members need not be concerned about organizing the LLC in a manner that would cause it to have a preponderance of corporate attributes.

### **Admission of Members after Formation**

After the LLC is formed, a person may become a member either by acquiring a membership interest directly from the LLC or as an assignment from a member. If the person acquires the interest from the LLC then all of the members must consent to the transaction unless the members have agreed to a lesser margin of consent. If they have agreed to a margin that is less than a majority of the interests, they risk causing the LLC to have the corporate attribute of free transferability of interests.

If the person acquires the interest through an assignment from a member, then the person becomes a member only if assignment includes both the financial rights as well as the governance rights of the assigning member. If the person is assigned only the financial rights of the assigning member, the person may receive the profits and distributions of the assigning member but cannot become a member.

### **Assignment of Membership Interest**

A member may assign its financial rights in whole or in part and, unless otherwise agreed by the members, need not obtain any consent or approval from the other members. The assignee of financial rights can receive the assignor's share in profits, losses and distributions but cannot participate in management or vote on any matter. Unless otherwise agreed by the members, an assignment of financial rights does not make the assignee a member and does not dissolve the LLC.

A member may assign its membership interest only by assigning its governance rights as well as its financial rights to the same assignee. Unless otherwise agreed, a member can assign its governance rights to another member without the consent of the other members. Unless otherwise agreed, a member can assign its governance rights to a non-member only if at least a majority in interest of the members consent to the assignment. The members may, by agreement, either require a more restrictive margin of consent for such assignment or a lesser margin of consent. The consent of the other members also constitutes the consent necessary to avoid dissolution which would otherwise ensue as a result of the assigning member ceasing to be a member. After the other members have duly consented, the effect of an assignment of governance rights is that the assignee becomes a member and the assignor ceases to be a member.

### **Dissolution and Continuance**

An LLC must dissolve upon the occurrence of an event specified in the articles of organization or the operating agreement or upon the unanimous consent of the members. The LLC can but need not actually dissolve upon the death, retirement or resignation of a member or any other event that causes a member to cease to be a member. The LLC can continue and not actually wind up as long as the remaining members unanimously agree to continue the LLC within 90 days after the date on which the event that caused a member not to be a member occurred.

If the members have agreed to continue the LLC when a member ceases to be a member, then that agreement shall control whether or not the LLC shall continue. The agreed procedure for continuing the LLC should provide for an affirmative vote to continue by the remaining members. The members may

agree on any margin of vote to continue. However, if the members decide on a margin of vote necessary to continue the LLC that is less than a majority or more in interest of the remaining members, the members should carefully consider the reasons for any such a margin.

## **V. CLASSIFICATION FOR FEDERAL INCOME TAX PURPOSES**

An LLC is not necessarily taxed as a partnership simply because it has been duly formed under a state LLC Act. Prior to January 1, 1997, the members had to assure that the LLC had not been organized in a manner that would cause it to be classified as corporation for tax purposes under the applicable provisions and regulations of the Internal Revenue Code, (I.R.C.). For all LLCs formed after January 1, 1997 and for all tax years after January 1, 1997 of all LLCs formed prior to January 1, 1997, the IRS regulations enable entities to self-classify.

The issue of corporation verses partnership tax classification arises in connection with any organization that is formed by two or more persons who intend to conduct business for profit and divide or apportion the gains. To determine how such an organization will be taxed, the I.R.C. requires that it be classified as either a corporation or as a partnership, (See generally Treasury Regulation '301.7701-2). That classification depends on whether the organization meets the I.R.C. definition of "corporation" or the I.R.C. definition of a "partnership".

The I.R.C. regulations define a partnership to include any type of unincorporated organization that conducts business but that is not a corporation. A corporation is defined to include associations, joint stock companies and insurance companies. The I.R.C. does not contain a definition of "association". While a "partnership" is essentially defined as any organization that is not a corporation it could conceivably be an "association". Decades of litigation and Internal Revenue Service (I.R.S.) rulemaking have been devoted to determining which type of organization is an "association" within the meaning of the definition of "corporation" for tax classification purposes and which type of business organization is not an "association" and, thus, classified as a "partnership" for tax classification purposes.

The term "corporation", on its face, means an organization that incorporates under the corporation laws of a state and such an organization will always be classified as a corporation. However, since the definition of "corporation" is not limited only to organizations that incorporate under a state law, the term "association" can include organizations that do not incorporate under a state law. The case law that construed the early versions of the I.R.C. developed a functional, rather than a substantive, definition of the term "association". An association came to be defined as an organization that had associates who were beneficially interested in the organization and who engaged in "some concerted volitional [business] activity" with the objective of dividing the gain from that business and which acted like a corporation in pursuing its business objective. That the organization was not formally denominated or organized as a corporation under any state law was irrelevant to whether or not it was classified as an association and taxed as a corporation.

In 1960, the I.R.S. developed regulations that "codified" the case law. The regulations set forth those corporate attributes which, if they predominate in the organization, will cause that organization to be an association and classified as a corporation. The regulations specify continuity of life, centralization of management, limited liability for the owners and free transferability of ownership interests to be corporate attributes.

If an organization is determined to have more than two of the foregoing corporate attributes, the organization will be classified as a corporation. If the organization is determined to have two or less of the foregoing corporate attributes, the organization will be classified as a partnership.

**Continuity of Life** means that, as a matter of state law or by agreement among the owners, the death, insanity, bankruptcy, retirement, resignation or expulsion of any owner does not cause the organization to dissolve, as dissolution is defined under the applicable state law.

**Centralized Management** means that the exclusive and continuing authority to make business decisions on behalf of the organization is concentrated in persons who may or may not be owners and whose decisions need not be ratified by the owners.

**Limited Liability** means that, as a matter of state law, a creditor of the organization cannot seek personal satisfaction from at least one owner if the assets of the organization are insufficient to satisfy the claim of the creditor.

**Free Transferability of Interests** means that an owner has the unconditional power to confer all of the rights and privileges of ownership in the organization on a person who is not an associate without the consent of the other owners.

### **Tax Classification of LLCs**

The enactment of the first LLC statute by Wyoming in 1977 presented the I.R.S. with an almost unprecedented tax classification issue. The I.R.S. had to consider whether the corporate attribute of limited liability was so fundamental to the concept of "corporateness" that an organization in which all of the owners had limited liability must always be classified as a corporation for tax purposes. The I.R.S. apparently was inclined to view limited liability to be so unique to corporations that any organization that had limited liability must necessarily be taxed as a corporation. Ultimately, however, the I.R.S. determined that no one corporate attribute including limited liability should be accorded any greater weight than the others in classifying an organization for tax purposes. Therefore, as with any other business organization, an LLC will be taxed as a partnership as long as it has two or less of the four corporate attributes described above.

The significance of the issue of the classification of LLCs for tax purposes has receded since 1993. To be taxed as a partnership, the members must assure that the LLC has not been organized to possess more than two of the four corporate attributes. Since the members will generally organize the LLC to possess limited liability, they must organize to avoid two of the three remaining corporate attributes. While there had been a measure of uncertainty as to how the I.R.S. would apply the corporate attributes to an LLC, that uncertainty has largely been removed by successive revenue rulings and by Revenue Procedure 95-10 (1995-3 IRB 20). Consequently, it is reasonably easy for the members to organize the LLC in a manner that will both cause the LLC to be taxed as a partnership and still preserve flexibility in governance, management and structure.

**Self-Classification Regulations (PS-43-95).** In 1995, the I.R.S. proposed to allow all domestic unincorporated business organizations including LLCs to choose whether to be classified as a partnership or as an association and taxed as a corporation, see Notice 95-14 (1995-14 IRB 7). A hearing on the proposed regulation was held on August 21, 1996 and generally favorable public comments were received. The self-classification regulations became final in December 1996 and took effect on January 1, 1997. The new regulations eliminate the corporate attribute analysis discussed above, and the members may choose whether to be taxed as a partnership or as a corporation. The tax classification has been effectively eliminated as an issue in forming and managing an LLC. In summary, the new regulations provide as follows:

Election of Classification: Any business entity including an LLC that is not classified as a corporation (i.e., any business entity that is not incorporated under some state corporations statute) and that has two or more associates can elect to be classified as either a partnership or as an association taxed as a corporation.

Election by Single-Member Entities: A single-member entity including a single-member LLC can elect either to be classified as an association taxed as a corporation or to have the separation of the entity from the owner disregarded. If the single-member entity elects to have the separation disregarded then the entity will be treated as a sole proprietorship for federal tax purposes.

Classification by Default: An LLC having two or more members that is formed after the effective date of the final regulations need not make any affirmative election and shall be classified as a partnership. The separation between the entity and the owner of a single member LLC will be disregarded unless the single-member LLC affirmatively elects to be classified as an association taxed as a corporation.

Method of Election: The business entity that seeks to avoid the default classification or to change its current classification must file an I.R.S. Form 8832 that is signed by all the members or by a person authorized by the members to sign. The election takes effect on the date of filing or a later date specified in the filing which date cannot be more than 75 days beyond the date of filing. Elections to change classification can only be made once every five years.

Transitional Rules: Business entities that were classified as partnerships before January 1, 1997 need not make any filing to maintain that classification.

Non-U.S. Entities: The regulations list certain types of non-U.S. entities that will always be classified as associations taxed as corporations. Generally, non-U.S. entities that are not so listed can elect their classification to the same extent as domestic entities. In the absence of an affirmative election, a non-U.S. entity will be classified as a partnership as long as it has two or more members and at least one member has unlimited liability. If, in the absence of an affirmative election, all members have limited liability, then the non-U.S. entity will be classified as an association and taxed as a corporation.

**Classification for State Tax Purposes.** Almost all states follow the tax classification principles of the IRS for the purpose of state tax classification. California imposes the same annual minimum franchise tax on LLCs that it imposes on corporations.

**Taxation of LLCs as Partnerships.** LLCs that are classified as partnerships will be taxed as partnerships under Sub-Chapter K of the I.R.C. Because the provisions of Sub-Chapter K contemplate conventional partnerships, certain taxation issues have arisen from those attributes of an LLC that partnerships possess. The following is a list of taxation issues of which the practitioner should be aware:

Because the rate of taxation on individuals is higher than the rate of taxation on corporations, it is possible that individuals organizing as a corporation may pay fewer tax dollars. A member must be materially involved in the business of the LLC to avoid the passive loss rules of the IRS. The transfer of more than 50% of the interests in the capital and profits of an LLC in any 12-month period may cause the LLC to terminate for tax purposes. The sale of an LLC interest is not entitled to the 50% exclusion applicable to the gain on the sale of shares of a corporation that is a qualified small business.



## VI. CONSIDERATIONS FOR OPERATING AGREEMENT

The Operating Agreement is the single most important document in any limited liability company (referred to as an "LLC"). It combines all of the functional attributes of a shareholder agreement, corporate by-laws and a partnership agreement. The LLC statutes contain default provisions that govern certain fundamental issues if the members of the LLC have not manifested an agreement on those issues. With a properly considered and well drafted Operating Agreement, the members can avoid the default solutions contained in the LLC statutes, if they so choose, and take full advantage of the flexibility offered by the LLC form.

In formulating the Operating Agreement, the practitioner should distinguish between and among the governance rights, financial rights and management rights of the members. Governance rights enable members to decide on the fundamental structure and include admission of new members, assignment of membership interests and dissolution. Financial rights enable members to receive distributions from the revenues of the LLC business. Management rights enable the members to conduct and pursue the business and business purpose of the LLC.

- A. Governance and Management: The LLC may be governed or managed either by the members or by manager(s) chosen by the members.
  1. If Member Managed, consider:
    - a. Voting Qualifications.
    - b. Voting Margins.
    - c. Issues Requiring Super-Majority Vote.
    - d. Vote Margin to Amend Articles of Organization and to Amend Operating Agreement.
    - e. Delegation of Management Issue to Committees of Members.
    - f. Authority of Members to Bind LLC to Third Parties
  2. If Manager Managed, consider:
    - a. Procedure for Choosing Managers.
    - b. Issues Requiring Ratification by Members and Vote Margin(s).
    - c. Duties of Managers.
    - d. Authority of Managers to Bind LLC to Third Parties
- B. Liability of Members and Managers to the LLC: The members can agree to limit or eliminate the liability of a member or manager to the LLC for any reason except for willful misconduct. If the members agree to limit liability, consider:
  1. Dollar Limit on Liability.
  2. Type of Liability.
- C. Indemnification and Contribution: The LLC can indemnify a professional member for the type of liability to which a professional member may be subject or contribute to a judgment against the LLC. If the LLC agrees to indemnify or contribute, consider:
  1. Dollar Limit on Indemnification or Contribution.
  2. Type of Liability and Conditions of Indemnification or Contribution.
- D. Contributions. A contribution is defined as anything of value that a person contributes to the LLC in that person's capacity as a member. There is no statutory restriction on the form of the contribution. Consider:
  1. If Cash Contribution, consider:
    - a. Time of Payment
    - b. Installments
    - c. Conditions and Security
  2. Form of Contribution, if other than cash.

3. Obligation of Members to Make Additional Contributions.
  4. Capital Calls.
  5. Remedies Upon Default on Contribution Obligation.
  6. Vote Margin Necessary to Compromise Contribution Obligation.
- E. Financial Provisions. The members are free to arrange the financial matters of the LLC in any many they deem appropriate. Consider:
1. Basis on which Profits and Losses are Allocated.
  2. Basis on which Distributions are Shared.
  3. Distributions to a Resigning Member.
  4. Types of Distributions.
    - a. Net Cash from Operations
    - b. Performance Based
    - c. Timing of Payment of Distribution
  5. Distributions on Dissolution.
    - a. Preferential Rights
  6. Pensions and Other Retirement Compensation
- F. Membership Status. The members may agree upon the time, the events and the conditions upon and under which a member may resign from the LLC. Consider:
1. Notice Period before Resignation takes Effect.
  2. Restrictive Covenant.
  3. Client/File Arrangements, (if professional practice).
  4. Calculation of Return of Contribution and Timing.
  5. Calculation of Distributions and Timing.
- G. Admission of New Members. The members may agree on the procedure and conditions for admitting new members to the LLC. Consider:
1. Qualifications for New Members.
  2. Timing and Procedure for Nominating New Members.
  3. Vote Margin for Admitting New Members.
- H. Assignability of Membership Ownership Interest. The members may set the terms and conditions upon which a member may assign a membership interest. Consider:
1. Free Transferability of Entire Interest (i.e. Financial Rights, Management Rights and Governance Rights)
  2. Free Transferability of Financial Rights Only.
  3. Restrictions or Conditions on Transfer of Management Rights and Governance Rights.
  4. Vote Margin for Approval of Transfer of Interest.
- I. Dissolution: The members may agree upon the events that shall cause the LLC to dissolve and the procedure for causing the LLC to continue after an event in dissolution has occurred.
1. Non-Statutory Events in Dissolution (i.e. other than unanimous consent, death, dissociation or bankruptcy of a member).
  2. Vote Margin to Continue After Event In Dissolution.
  3. Terms of Winding Up Absent Vote to Continue.
  4. Distributions on Dissolution.
- J. Mergers and Acquisitions. Consider:
1. Restrictions on Mergers and Acquisitions.
  2. Vote Margin Required for Merger or Acquisition.
- K. Fiduciary Duties Among Members. Consider:
1. Duty of Loyalty
  2. Duty of Care
  3. Duty to Act in Good Faith
  4. Duty to Refrain from Self Dealing

5. Duty Not to Compete with LLC or Not to Usurp An LLC Opportunity
6. Duty to Use LLC Property or Assets only for the Benefit of the LLC

## VII. LLCs AND OTHER LAWS

**Bankruptcy Laws.** Although the Bankruptcy Code does not refer to LLCs, LLCs that seek the protections of the Bankruptcy Code will likely be deemed a "person" and entitled to relief. However, it is less clear whether an LLC will be treated as a partnership or corporation for the purpose of filing and administering the case in bankruptcy.

**Securities Laws.** An offer or sale of a membership interest will be subject to federal and state securities laws if a membership interest is deemed to be a security. While there is a view that membership interests are not securities per se, the better view is that they are securities but that a transaction involving the offer or sale of membership interests may be exempt from registration if the transaction is conducted as a private or limited offering.

**Federal Elections Law.** The Federal Elections Commission (FEC) has acknowledged that LLCs do not meet the definitions of either corporations or partnerships under federal elections laws. However, an LLC is a "person" and subject to limitations on political contributions. Unlike a partnership, LLC contributions will not be attributed proportionately to the limits applicable to each member, (See FEC Advisory Opinions 1996-13, 1995-11).

**Federal Subject Matter Jurisdiction.** Under federal subject matter jurisdiction, a person or entity can sue or be sued in a federal district court only if the matter involves a substantial federal question (federal question jurisdiction) or if the state citizenship of the adverse parties is completely diverse and the amount in controversy exceeds \$75,000 (diversity jurisdiction), (See 28 U.S.C. 1331, 1332). If the action is based on federal question jurisdiction, the juridical character of an LLC is irrelevant. If, however, the action is based on diversity jurisdiction, the juridical character of an LLC as a non-corporate entity renders it incapable of having state citizenship for diversity purposes. Like a partnership, the state citizenship of each member must be diverse with each adverse party. If any member has the same state citizenship as any adverse party, then the federal district court lacks subject matter jurisdiction to hear the action.