DANIEL R. SCHRAMM, L.L.C.
Attorney at Law
121 Chesterfield Business Parkway
Chesterfield, Missouri 63005
Phone: (636) 532-2300
Fax: (636) 532-6002
Email: daniel@dschrammlaw.com
Web site: www.dschrammlaw.com

I. WHY LIMITED LIABILITY COMPANIES?

A. History and Types of LLCs

Historically, the limited liability company was conceived as a form of business ownership that would function like a partnership, but with the limited liability protection of a corporation. Wyoming adopted the first LLC statute under this framework in 1977. (1977 Wyo. Sess. Laws 537-549, effective Mar. 4, 1977.) Wyoming passed the law to attract business to the state. Florida passed a similar statute five years later. [See, Fla. Stat. Ann. §§608.401-471 (2001).] The question for the IRS, however, was whether to treat this new LLC entity for tax purposes as a partnership with pass-through status or as a corporation. Small business owners often viewed corporate tax law as especially unfavorable. If the LLCs were treated as C corporations, the shareholders faced double taxation at the corporate and shareholder level. Business owners could form S corporations to provide some pass-through relief. But the IRS imposed strict limits on the number and types of shareholders, as well as class structure, and the states imposed strict rules for corporate compliance.

Back in 1980, the IRS initially proposed classifying the newly created LLCs as corporations. (See, Prop. Treas. Reg. §301.7701-2(a), 45 Fed. Reg. 75709, Nov. 17, 1980.) In reaching this conclusion, the IRS focused on traditional corporate characteristics like continuity, transferability of ownership interests, and centralized management. The IRS withdrew its initial proposal, but the IRS nonetheless issued a

private ruling in 1981 that still classified an LLC as a corporation. (I.R.S. Priv. Ltr. Rul. PLF 83-04-138, Oct. 29, 1981.) Because the IRS was reluctant to give favorable tax treatment to LLCs, business owners looked to alternative structures like limited partnerships to gain tax advantages, especially for real estate investments. But the limited partnership offered limited liability protection only for passive investors.

By 1988, the IRS issued a Revenue Ruling that a Wyoming LLC could be taxed as a partnership. (Rev. Rul. 88-76, 1988-2 C.B. 360.) This Revenue Ruling opened the floodgates for the creation of LLC statutes across the country. By 1996, every state in the country had an LLC statute. Missouri adopted its LLC statute in 1993.

Faced with the onslaught of LLCs across the county, the IRS gave up trying to draw classification rules to evaluate what kind of tax status would apply to a particular business entity. The IRS issued a treasury regulation allowing small business owners operating as an LLC to "check the box" and decide for themselves whether they wished to be taxed as a partnership or a corporation. (Treas. Reg. 301.7701-1-3.) The final "check the box" regulation became effective January 1, 1997. (61 Fed. Reg. 66584 Dec. 18, 1996). So now, if it is strategically advantageous from a tax standpoint for an LLC to retain revenues and pay reasonable compensation to its officers, the LLC may elect to be taxed as an S corporation. This "check the box" rule opens up the types of LLCs to a host of different possibilities. The LLC format offers greater flexibility than the formal corporate structure. Yet the potential tax advantages of an S corporation are still available.

Despite the flexibility created by the "check the box" rule, most small business owners operating as LLCs still follow the traditional format of acting like a general partnership with limited liability protection. A single member also may operate as an LLC to gain the same liability protection. Many small business owners operate as single member LLCs for this purpose. The owners of the LLC are called "members." The

membership interest may be reflected in "membership units," like shares of stock. Or the membership interest may be reflected as a percentage ownership interest in the company. The members may be individuals or other kinds of business entities. So the membership of the company could include entities like corporations, trusts, or other LLCs. Profits and losses usually are allocated among the members based on capital contributions. A single member LLC typically will be taxed on net profits like a sole proprietor.

The limited liability company offers all the simplicity and flexibility features of a partnership, without the strict corporate formalities. So for example, the members only need to file a set of articles of organization with the Secretary of State and to keep an operating agreement in their files. The owners are not required by law to issue shares of stock, conduct annual meetings, or file annual reports with the state.

Just like with a partnership, the relationship among the members is governed by contract. The contract is called the operating agreement. If the operating agreement is silent on a particular subject, the Missouri LLC statute controls. Ultimately, the rights, duties and obligations of members and managers spring from a combination of the Missouri statute, the operating agreement and the articles of organization. *Hibbs v. Berger*, 430 S.W.3d 296, 314 (Mo.App. E.D. 2014)

B. The State Statute

Turning to the Missouri statute, any business owner or owners operating as an LLC in Missouri must comply with the basic rules of the Missouri Limited Liability Company Act, §347.010, et seq.[1] The Company may have multiple members, or it may be a single member company expressly authorized under §347.017.

[1] All references to Missouri statutes are to RSMo (2016).

1. The Articles of Organization

Starting with the very beginning, any person or persons wishing to form a limited liability must file articles of organization with the Missouri Secretary of State. The articles must state: (1) the name of the company, (2) the purpose or purposes of the business, (3) the name and address of the registered agent and registered office in Missouri, (4) whether the management of the company is vested in managers or members, (5) the events by which the company is to dissolve or the number of years the company is to exist, which may be any number or perpetual; and (6) the name and address of each organizer. §347.039. The organizer or organizers signing the articles do not have to be members.

I believe it would be useful to provide a few points of clarification about the required elements of the articles. The name of the company must contain the words "limited company" or "limited liability company" or the abbreviation "LC", "LLC", "L.C." or "L.L.C." §347.020(1). The name may not include the word "corporation", "incorporated", "limited partnership", or "Ltd.", or any similar words or abbreviation that imply the company is anything other than an LLC. §347.020(2). Like with a corporation, the use of the name reserves its use for that particular entity and deprives others from filing under the same name. Whatever name is chosen for the LLC, it is important to put the limited liability company designation on all letterheads, checks, signs, and contracts to avoid the claim by a third party that a person was acting individually and not on behalf of the LLC.

Most organizers will say in the articles that the duration is perpetual. This avoids the problem of forgetting to "replace the light bulb" and not extending the duration when the expiration date arrives.

The business owners must evaluate whether the management should be vested in managers or members after considering the particular circumstances of the business. A manager-based company has a specified number of managers appointed by the owners. The managers do not have to be members, although they typically are members. This structure is similar in some respects to the board of directors of a corporation. A member-managed company, on the other hand, will have the members managing the company directly on the basis of their respective ownership interests – more like the decision-making process of a traditional partnership. The lawyer must be attuned to the clients' desires and needs in proposing an approach that makes the most sense for the business.

2. The Operating Agreement

A common misconception about limited liability companies is that the creation of an operating agreement is unnecessary under Missouri law. Many owners of limited liability companies – especially the owners of single-member companies - believe they have met all statutory requirements by paying the filing fee and filing their articles of organization with the Secretary of State. Not so. An operating agreement does not have to be filed with the State. And the member or members have broad discretion to spell out what to include or not include in their operating agreement. But the obligation to create one is mandatory under §347.081.

By definition, an operating agreement is "any valid agreement or agreements, written or oral, among all members, or a written declaration by the sole member concerning the concerning the conduct of the business and affairs of the limited liability company and the relative rights, duties and obligations of the members or managers, if any." §347.015(13). The members have broad discretion to include in their operating agreement provisions on the following topics:

(1) vesting the management of the company in the managers or members, and imposing

limitations on how those management powers may be exercised;

(2) providing classes of members with different rights, powers and duties;

(3) dividing the exercise of management or voting rights among the different classes;

(4) providing for meeting notices, actions by consent, waiver of notices, quorum requirements, authorization by proxy, and any other matters over the exercise of voting or approval rights;

(5) authorizing certain managers or members to execute or file documents on behalf of the company;

(6) restricting the transfer of membership interests, including buy-sell provisions in the event of death or disability, and giving rights of first refusal for any offers by third parties.

(7) allocating income gains, deductions, losses, and credits among the members; and

(8) making tax elections and authorizing managers or members to make such elections.

See, §347.081.1.

So, the member or members have great flexibility to include any provision, not inconsistent with the law, to govern the affairs of the company and their rights and duties as members. §347.081.1. And the agreement may include oral promises, so long as the members have a valid contractual agreement. §347.015(13). Yet make no mistake. The obligation to create the agreement is mandatory under the Act:

> The member or members of a limited liability company *shall adopt an operating agreement* containing such provisions as such member or member s may deem appropriate, subject only to the provisions of sections 347.010 to 347.187 and other law….

§347.081.1 (emphasis supplied).

A small business owner may ask, so what? What is the practical effect of ignoring this requirement if you never have to file an operating agreement with the State? The greatest danger could happen when a creditor or claimant brings a lawsuit against the company. Upon learning that the company has no operating agreement, the claimant then might try to "pierce the company veil." If the member or members commingle personal assets and fail to observe statutory formalities, a court might well pierce the veil and hold the members personally liable.

3. Limited Liability Protection

Members ordinarily create an LLC to limit their personal exposure to liability for the company's actions, or for the actions of other members or managers. I often hear small business owners complain that the creation of an LLC will have no practical impact. It is true that the LLC will not insulate the member from personal liability for his or her own tortious conduct. So, for instance, a member could not use the LLC to avoid personal liability for his or her own acts of fraud. Nor could a lawyer, doctor, insurance broker or accountant use the company to avoid personal liability for professional malpractice. And if the member personally guarantees a company's lease or other debt obligations, the LLC will not insulate the member from personal liability under the guaranty.

Yet the Missouri Limited Liability Company Act is clear. Under the Act, a person who is a member or manager of a limited liability company is not subject to liability for company's obligations or the acts of others solely by reason of being a member or manager:

> A person who is a member, manager, or both, of a limited liability company, or both, is not liable, solely by reason of being a member or manager, or both, under a judgment, decree or order of a court, or in any other manner, for a debt,

> obligation or liability of the limited liability company, whether arising in contract, tort or otherwise or for acts or omissions of any other member, manager, or agent or employee of the limited liability company.

§347.057.

The Southern District applied this statutory protection to absolve an LLC member from any personal liability on an unjust enrichment claim. *JF Contr., Inc. v. Bierman*, 147 S.W.3d 814, 819 (Mo.App. S.D. 2004). The court noted that the opposing party in a contract dispute failed to show how the member was benefited individually and not as a member of the limited liability company. The Southern District thus reversed a $2 million judgment against the member.

The Eighth Circuit also applied §347.057 to criticize a bankruptcy court for its erroneous conclusion that the creditors of an LLC in bankruptcy had to be paid before a member received her individual share from the settlement of a lawsuit. *Debold v. Case,* 452 F.3d 756, 762 (8th Cir. 2006). Because of the rule that neither the managers nor members were liable for the company's debts, the bankruptcy court erred in its allocation of the settlement proceeds. *Id.* at762.

I admit this sampling of decisions is small. But the decisions confirm an important point. A small business owner is far better off with the statutory protection of §347.057 than to be subject to an unlimited personal risk. The statute will not insulate a member from liability for his or her own wrongful or tortious acts. Nor will it protect a member who signs a personal guaranty. Yet the statute will protect the member from liability for the intentional or negligent torts committed by another member or manager. And it can protect the member from liability for any breach by the company on a contract with one of its customers or suppliers. In most instances, this kind of protection also should insulate the members from personal liability if someone is injured on the company premises.

C. Comparison to Other Entities

The LLC gives small business owners the advantages of simplicity and flexibility, while preserving the goal of limited liability protection. Despite these kinds of inherent advantages, business owners may have particular reasons for choosing other forms of business ownership. This section is designed to provide summaries of some of the other major kinds of business entities for comparison purposes.

1. C Corporations

The designation of a Missouri corporation as a "C corporation" is a classification for tax purposes under the Internal Revenue Code. See, 26 U.S.C. §1361 (a)(2). It is not a designation that exists under the General and Business Corporation Law of Missouri. See, §351.010 et seq. A different speaker in this program will compare the tax treatment of a C corporation to an LLC in greater detail. But generally, the C corporation must report its income and expenses on its own tax return, and the profits are subject to a corporate income tax. The shareholders are taxed individually on any dividends they receive. And for a small business corporation, this creates what is commonly known as the problem of double taxation.

Historically, small business owners often used the general for-profit corporation as the most common form of business ownership. Just like the members of an LLC, the shareholders are protected for most purposes from personal liability for the debts and obligations of the corporation. But shareholders still could be personally liable if they personally commit independent tortious acts or serve as personal guarantors for corporate debts. The stockholder pays some form of consideration for any stock purchased, and that ordinarily is the extent of the shareholder's liability. Just like with an LLC, the shareholder could be personally liable if a creditor or other claimant is able to "pierce the

corporate veil." A court may pierce the veil if it finds that the corporation did not observe proper corporate formalities, had insufficient capital, commingled assets, or if the shareholder or shareholders improperly acted as the alter ego for the corporation.

The General and Business Corporation Law of Missouri imposes strict ground rules for the operation of a corporation. The board of directors is ultimately responsible for the management of the corporation. The stockholders elect the members of the board. The stockholders vote their shares under prescribed rules. The officers ordinarily conduct the day-to-day operations of the corporation. The board of directors appoints the officers, so the officers serve at the pleasure of the board. The corporation must identify board members and officers in annual reports filed by the corporation with the Missouri Secretary of State. An LLC does not have to file such annual reports.

2. S Corporations

Just like with a C corporation, the designation of a corporation as an "S corporation" is a classification used by the IRS for tax purposes. See, 26 U.S.C. §1361 (a)(1). It is not a designation that exists under the General Business and Corporation Law of Missouri. An S corporation must comply with the same requirements as other for-profit corporations under Missouri law.

For tax purposes, the S corporation is a pass-through entity and the shareholder is taxed on his or her share of the corporate income on his or her personal tax return. In evaluating this issue, the shareholder may be taxed on his or her reasonable salary as a corporate officer. The S corporation may be able to take advantage of certain tax deductions and payments to qualified benefits plans. And the corporation may be able to retain earnings from one year to the next. This approach often gives the business owners a tax advantage over a partnership tax if the business regularly generates substantial income on an annual basis.

But the Internal Revenue Code imposes some strict requirements on who may be a stockholder for an S corporation. For example, a person cannot serve as stockholder if the person is a nonresident alien. See, 26 U.S.C. §1361 (b)(1)(C). And a trust ordinarily may be a stockholder only if it qualifies under strict rules for qualified subchapter S trusts. 26 U.S.C. §1361 (d). The law only permits one class of stock. 26 U.S.C. §1361 (b)(1)(D). And rules limit the amount of loss that a stockholder may claim on his or her personal return. Real estate investors thus may view the S corporation as an inappropriate vehicle for their investments because of the limitations on depreciation and similar losses.

These kinds of tax considerations are varied and complex. Lawyers should consult with the company's accountant or tax lawyer to determine if an S election makes sense for the particular business.

3. General and Limited Partnerships

Many small businesses in Missouri operated as general partnerships prior to the adoption of the Missouri LLC statute in 1993. But under current law, I personally find little justification for forming a general partnership with unlimited personal liability. General partnerships, to the extent they still exist, continue to be governed by the Missouri Uniform Partnership Law. §358.010 et seq. A general partnership is defined as an association of two or more persons to carry on a business as co-owners for profit. §358.060. No filing is required to form the partnership.

Just like LLCs, partnerships provide flexibility in management and ownership by contract under a partnership agreement. The partners usually allocate their profits and losses based on capital contributions. Unless an LLC "checks the box" and elects to be taxed as an S corporation, most LLCs are taxed on the same basis as partnerships. But the major distinction between a partnership and an LLC is that the total assets of each partner are at risk – not just the partner's capital contribution.

Limited partnerships offer a hybrid form of partnership that creates a special class of limited partners who provide capital but do not participate in management. Like the members of an LLC, these limited partners are generally protected from liability for anything beyond their capital contribution. The general partner in such an arrangement manages the business and has unlimited personal liability. For obvious reasons, the general partner often will form a corporation or LLC to limit its exposure. To form a limited partnership, all the general partners must sign a certificate of limited partnership. They must state the name of the limited partnership, the name and address of registered agent and office, and the duration of the entity. §359.091. The name must include the word "limited partnership" or the abbreviation "LP" or "L.P." §359.021.

4. Other Entities

Professional businesses have two other options for business formation. If all the shareholders are professionals of a licensed profession like lawyers, physicians or accountants, the shareholders may form a professional corporation. The incorporators must produce a certificate issued by the licensing authority of their profession prior to the issuance of the articles of incorporation, and some special additional requirements are imposed if more than one professional service is authorized to be practiced in one corporation. See, §356.041. The professional corporation is subject to the same general reporting requirements as other corporations. (§356.690.) And the name must include the words "Professional Corporation" or the abbreviation "P.C." §356 071.

Another option for professionals is to form a limited liability partnership, or LLP. A partner in a registered LLP is liable for the partner's own wrongful acts but not for those of the partnership or other partners. A partnership may register as an LLP by filing an application with the Missouri Secretary of State. The application must include the name of the partnership, the name and address of the registered agent and registered

office, the number of partners, a brief statement about the formation of the partnership, principal business, and a statement that the partnership has applied for registration as a registered limited liability company. §358.440. The application must be signed by the partners and renewed annually. The partnership name must use the words "registered limited liability partnership" or the abbreviations "LLP" or "L.LP." §358.450.

D. Who Should Use LLCs?

Because of the wide range of options available, I will not try to issue any kind of broad proclamation about who should use the limited liability company as a form of business ownership. The LLC offers greater simplicity and flexibility than most other forms of ownership, and this structure is especially appropriate where everyone is actively involved in the business. And, of course, the LLC offers the limited liability protection not given to sole proprietors or general partners. The "check the box" rule adopted by the IRS now offers even greater flexibility to permit the members of the LLC to elect whether the business should be treated for tax purposes as a partnership or a corporation. Yet the corporate form of ownership has a much longer history and, therefore, larger body of predictable case law. The client must make the final decision of what form of ownership makes the most sense. The lawyer should make the appropriate recommendation after considering all relevant factors in consultation with the client's tax lawyer or accountant.