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Easing Default Provisions of State Limited Liability Company Statutes in the Context of a Transfer of Interest in a Small Business

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NOTE

EASING DEFAULT PROVISIONS OF STATE LIMITED LIABILITY COMPANY STATUTES IN THE CONTEXT OF A TRANSFER OF INTEREST IN A SMALL BUSINESS

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I. INTRODUCTION

From the perspective of a small, inexperienced businessperson, default provisions governing transferability of interests in most state limited liability company statutes contain invisible pitfalls which

prevent full membership rights from automatically transferring with the purchase of an interest in a limited liability company ("LLC"). Because these default provisions prevent free transferability of full membership interests, the layman who purchases an LLC interest may not realize that, in most states, such a transaction is basically a passive investment, which denies the assignee any managerial powers in the LLC. Such a result conflicts with the goals of an assignee who purchases an LLC interest as a sole means of earning a livelihood. In effect, default provisions of state LLC statutes that forbid transfer of managerial rights directly to an assignee contradicts a small businessperson’s reasonable expectation of


2. See Larry E. Ribstein, The Emergence of the Limited Liability Company, 51 BUS. LAW. 1, 5 (1995) (noting that some limited liability companies “may have important internal reasons to . . . permit free transferability”).

3. It has been suggested that election of the LLC form is most beneficial where the entity is a “closely held, high liability enterprise[]” (e.g. construction, mining and drilling). . . . These organizations will benefit from the corporate safeguard of limited liability protection while enjoying the favorable tax status of a partnership.” CT CORPORATION SYSTEM, CT CORPORATION SYSTEM INTRODUCTION TO LIMITED LIABILITY COMPANIES, XIII (Oct. 1, 1992) (unpaginated).

In general, LLCs have a relatively circumscribed role and purpose. The LLC entity form is useful in the following enterprises which have “a small number of active investors:” entrepreneurial businesses, family businesses, “passive investments, high technology businesses, venture capital projects, theatrical, real estate and oil and gas investments, . . . corporate joint ventures, . . . professionals (accountants, attorneys, doctors, etc.), debt offerings[,] . . . structured finance transactions, and . . . foreign investors.” Brian L. Schorr, The New York Limited Liability Company Law and Professional Limited Liability Partnership Provisions, in FORMING AND USING LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS 1994, at 299, 301 (PLI Corporate Law & Practice Course Handbook Series, No. B-869, 1994).


Limited liability companies are privately-held largely because of federal tax consequences. . . . A limited liability company would be taxed as a corporation if it were publicly traded. . . . Section 7704 of the Internal Revenue Code taxes publicly-traded partnerships as corporations. . . . Thus, going public would frustrate a principal purpose of forming a limited liability company.

Id. (footnotes omitted); see id. at 34 n.26 (noting that publicly traded LLCs would lose their partnership treatment for federal income tax purposes).

4. See generally infra part III (analogizing problems that minority shareholders confront in close corporations to assignees of LLC interests).
protecting her investment through daily, hands-on management of the small business. It is rather ironic that one of the fundamental tenets that underlies LLC law is protection of the freedom to contract,⁵ which is guided by the parties’ reasonable expectations.⁶ Current state law which denies free transferability violates a small businessperson’s reasonable expectations.

After the Internal Revenue Service (“IRS”) initially promulgated the elements that an LLC must satisfy in order to receive a favorable partnership classification for federal income tax purposes, states began to enact their own LLC statutes patterned on the IRS’ model.⁷ As a result, states basically required non-transferability⁸ of LLC membership interests as a means of preserving a partnership classification for federal income tax purposes.⁹

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7. See infra part II.

8. Initially, the IRS required for federal income tax purposes unanimous consent from all the remaining members in an LLC before an assignee could enjoy the rights and powers associated with full membership. See Rev. Rul. 88-76, 1988-2 C.B. 360, 361 (“[T]he assignee or transferee does not become a substitute member and does not acquire all the attributes of the member’s interest ... unless all the remaining members approve the assignment or transfer.”).

Several months ago, the IRS unveiled a proposal to simplify entity classification for federal income tax purposes ("Proposed Rules"). In a shift from its original ruling that required non-transferability of full membership interests in an LLC to satisfy tax requirements, the IRS now permits a default partnership classification of eligible entities for federal income tax purposes. As a result, non-transferability of full membership powers may no longer be an integral element that enables an entity to gain favorable tax treatment. This Note argues that, in effect, the states’ default non-transferability requirements are now outmoded and that states should amend their statutes in order to permit assignment.


11. See supra note 9.

12. See infra part IV.

13. [T]he [state] LLC provisions on transfer make little sense apart from tax considerations. First, given the limited liability of LLC members, the transfer of management rights in an LLC is not the sort of momentous event that it may be in a general partnership. It follows that the decision-making costs of a unanimity requirement are likely to outweigh the benefits in most firms. The . . . most questionable aspect of statutory restrictions on transfer of management rights is the mandatory character of some statutes. . . . [T]here is little justification for reducing the flexibility of contracting by LLCs. . . . This is particularly so in light of the fact that the IRS has shown increasing flexibility and that a firm that permits free transferability may be able to establish that it lacks free transferability and continuity of life.

Ribstein, supra note 2, at 15 (footnotes omitted); see also infra note 65 and accompanying text.
of interests which will then conform with a small businessperson's expectation of management rights which would accompany a transfer of interest.

Because of the IRS' Proposed Rules, there are currently two possible situations. The first scenario ("Scenario 1") will assume that the Proposed Rules are approved in their current form. Until the Proposed Rules become final, the second situation ("Scenario 2") is the state of transferability under current law. By contrasting Scenario 2 against Scenario 1, this Note concludes that it is reasonable for the states to adopt the IRS' liberal approach to transferability of full membership rights in an assignment of interest to the small businessperson.

Transferability of an interest in an LLC is affected by the level of consent that is required before an assignee is granted full membership rights from the original LLC members. An interest is fully transferable when a transferor is able to freely assign her full rights of membership to an assignee without initially obtaining consent from the remaining members of the entity. Generally, under current law, the member must be able to transfer an economic right and voting and management rights to the assignee before free transferability exists for federal income tax purposes. By requiring unanimous consent from the remaining members, most state default requirements have also impliedly adopted this definition of full transferability. This Note examines the transferability issue in light of the interrelation among state LLC statutes, the Proposed Rules, and the effect of Revenue Procedure 95-10.

The first conflict may arise from adoption of the Proposed Rules. According to this announcement, the present entity classification system ("Resemblance Test") for federal income tax purposes may be vastly simplified. Under the current Resemblance Test, four prongs are used...

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15. See Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993). For an in-depth discussion of free transferability, see infra part V.D.
17. See supra note 9.
19. For a description of this test, see infra part V.
20. Additionally, "[e]limination of the classification regulations with respect to domestic LLCs and limited partnerships will save taxpayers and the Service substantial transaction costs without adversely affecting the revenue base derived from the corporate tax." See Susan P. Hamill, The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating
to determine whether an LLC will be classified, and therefore taxed, either as an association taxable as a corporation or as a partnership.\textsuperscript{21}

In general, an LLC should be classified as lacking free transferability in order to retain its beneficial partnership tax status\textsuperscript{22} under the present Resemblance Test. The Proposed Rules permit eligible future unincorporated entities to default into or to select partnership tax rates. As a result, such a system will eliminate the current Resemblance Test. Therefore, the Proposed Rules permit free transferability of membership interests, in lieu of the Resemblance Test's restrictive stance on the transfer of management rights. Upon finalization of the Proposed Rules, this effect will be in direct conflict with the default provisions of state LLC statutes that do not permit free transfer of management rights.\textsuperscript{23}

\section*{II. HISTORICAL OVERVIEW}

The basic forms of doing business and the laws\textsuperscript{24} which govern relationships between business people, or entrepreneurs, and the public, have evolved along with the needs and demands of the economy and the business community.\textsuperscript{25} As market complexity grew exponentially, the sole proprietorship evolved into the collegial partnership model.\textsuperscript{26} Partnerships then grew from small businesses between friends and neighbors to organizations which became cumbersome due to management decisions being based on majority (or greater) voting requirements\textsuperscript{27} and the unlimited liability of partners.\textsuperscript{28} The demand for more
efficient management and a reduction of partner liability then led to the creation and the proliferation of limited partnerships, which are statutory creatures with centralized management by a general partner. The additional hunger for a larger pool of capital and limited liability then led to the statutory creation and general adoption of corporations.

One could argue that the LLC is the next natural step along the

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28. According to the Uniform Partnership Act, partners are “jointly and severally” liable for torts committed by other partners and are also jointly liable for contracts conducting partnership business, although “any partner may enter into a separate obligation to perform a partnership contract.” UNIF. PARTNERSHIP ACT §§ 13, 15(a)-(b) (1914).

29. Limited partnerships offer limited partners limited liability, which is analogous to a shareholder’s exposure in a corporation. Under both of these business organizations, the separation between management and ownership interests entitle the investor to immunity from unlimited personal liability from business obligations. Therefore, both the limited partner and the shareholder are denied managerial power in order to avoid conflicts of interest. If the limited partner participates in management, the limited partner will lose her shield from liability. John G. Schmalz & Samuel P. Starr, IRS Provides Welcome Certainty in the Classification of LLCs as Partnerships, 82 J. TAX’N 260, 262 (1995) (“[A] limited partner that becomes too involved in managing the partnership runs the risk of losing limited liability.”). See generally LEFKOWITZ & AKSELRAD, supra note 14, § 1.3 (comparing LLCs, limited partnerships, S corporations, C corporations and limited liability partnerships in terms of business and tax considerations in tabular form).


By the third quarter of the nineteenth century . . . [industrialization] meant the concentration and centralization of economic power, not in governmental agencies but in autonomous corporations. Through the instrumentality of this new business form, human and material resources of unprecedented magnitudes were brought together as integral operating organizations.

. . . Control was no longer strictly a function of private ownership. . . . Rather, temporal power came to reside in a race of “artificial” persons, gigantic, immortal, without souls—the corporations.

Id.

31. Solo explains that after the Civil War, the watershed case of Santa Clara County v. Southern Pac. R.R., 118 U.S. 394 (1886), held that a corporation would be treated as a person who is entitled to constitutional rights granted by the Fifth and Fourteenth Amendments. Id. As a result, “the right of incorporation [had] become a common right and the corporate form [also had] become commonplace.” Id.

32. As corporations grew, the next logical progression was the creation of monopolistic enterprises. JONATHAN HUGHES, AMERICAN ECONOMIC HISTORY 348 (3d ed. 1990) (noting that monopolies were viewed by some as “a capital-saving innovation . . . with corporate management as the efficiency-promoting device: more income from less capital expenditure”).

“Traditional legal texts often classify business organizations along a continuum of complexity, ranging from the simple sole proprietorship on one end and moving through general partnerships, limited partnerships, and finally, corporations on the other end.” Thomas E. Geu, Understanding the Limited Liability Company: A Basic Comparative Primer (pt. 1), 37 S.D. L. REV. 44, 46 (1992).

New York was the first state “to enact a statute permitting the routine incorporation of businesses.” Samuelson, supra note 26, at 650 n.35.
evolutionary spectrum of business entities. Because business has demanded an entity form that combines the lower tax rate of partnerships, while retaining the limited liability offered by corporations, forty-nine states and the District of Columbia have enacted LLC statutes. In effect, LLCs are hybrids that have retained the most favorable characteristics of both partnerships and corporations. Although there was some initial reluctance by the IRS to recognize LLCs as viable entities, the IRS’ validation of the Wyoming LLC statute, which

33. See Geu, supra note 32, at 50 (“In sum, the LLC is an evolutionary [statutory] creature . . . .”); see also Ribstein, supra note 2, at 2 (noting that limited liability companies “are best understood in light of the development of the LLC as an alternative to existing business forms”). Additionally, “[t]he explosion of LLC law in the few years since 1988 confirms . . . the existence of a strong pent-up demand for this form of business.” Id. at 4.

34. Business has a legacy of lobbying the government successfully both on the federal and state levels. During the early twentieth century,

HUGHES, supra note 32, at 348; see SOLO, supra note 30, at 187 (asserting that a corporation’s “activities and responsibilities overlap and, in important areas, merge with those of the political authority”); see also KENNETH M. DOLBEARE & LINDA J. MEDCALF, AMERICAN IDEOLOGIES TODAY: FROM NEOPOLITICS TO NEW IDEAS 82, 115 (1988) (citing corporatism as a strand or school of political thought that views corporations or businesses as influencing government under the cloak of national interest and unity while in reality lobbying government in pursuit of self-advancement).

35. See supra note 1 (citing LLC statutes for all states except Vermont, which has pending LLC legislation as of September 28, 1996).

36. Susan Kalinka, The Limited Liability Company and Subchapter S: Classification Issues Revisited, 60 U. CIN. L. REV. 1083, 1103 (1992); C. Timothy Spainhour, Case Note: Limited Liability Companies in Arkansas: The Knowns and the Unknowns, 16 U. ARK. LITTLE ROCK L.J. 27, 27 (1994) (“The purpose behind the enactment of the LLC legislation was to create a business entity which would offer investors the limited liability of a corporation while qualifying for taxation as a partnership.”). According to Professor Geu, the LLC . . . attempts to provide limited liability to its members (like a corporation) and pass-through tax treatment (like a partnership). It is rooted in the traditions of the partnership association (in the United States) and the limitadas (from other countries). Its apparent purpose is to encourage investment and to attract business and investment from outside the state of its organization.

Geu, supra note 32, at 50.

37. See infra note 41 and accompanying text.

38. See Rev. Rul. 88-76, 1988-2 C.B. 360, 361 (holding that under the Wyoming LLC Act, the entity at issue should be “classified as a partnership for federal tax purposes”).

was the nation’s first LLC act, led to a wider acceptance of the LLC as a new business entity.

III. LIMITED LIABILITY COMPANIES AND CLOSE CORPORATIONS: SHARED “GENETIC” FAULTS

As “cousins,” the LLC has inherited both similarities and defects encountered by its kin, the close corporation.

LLCs resemble close corporations in several important aspects. "The LLC possesses many of the business traits found in close corporations, including, for the most part, limited liability protection for all members and the flexibility to adopt individualized agreements addressing the management, dissolution and transferability of the business.”

Many close corporations serve as the sole source of income for their shareholders. One characteristic of a close corporation is that “partici-

Wyoming Secretary of State)).
40. Geu, supra note 32, at 45. The Wyoming LLC statute was enacted in 1977, five years before any other state adopted LLC legislation. Id.
41. See LEFKOWITZ & AKSELRAD, supra note 14, § 1.4.3. “The uncertainty [before Rev. Rul. 88-76] regarding whether the Internal Revenue Service . . . would classify the LLC as a partnership, however, slowed the use of the new organization and arrested legislative development [of the LLC statutes].” Geu, supra note 32, at 45.

The nationwide trend toward recognition and acceptance of the limited liability company . . . continued . . . As of November, 1994, only two states—Hawaii and Vermont—lacked an LLC statute of one form or another. . . . [T]here is some concern [however] that the favorable treatment afforded by the Internal Revenue Service . . . may eventually come under congressional scrutiny if it results in a significant revenue loss to the United States government.

Alan W. Tompkins, Corporations and Limited Liability Companies, 48 SMU L. REV. 1019, 1028-29 (1995); see Spainhour, supra note 36, at 28 (noting that the IRS’ Wyoming LLC ruling “set the stage for rapid development of the new entity across the nation”).
42. See Hamill, supra note 20, at 566-67.
43. Id.

“Unlike the typical shareholder in a publicly held corporation, who may be simply an investor or a speculator and cares nothing for the responsibilities of management, the shareholder in a close corporation is a co-owner of the business and wants the privileges and powers that go with ownership. His participation in that particular corporation is often his principal or sole source of income. . . . In his capacity as an officer or employee of the corporation, he looks to his salary for the principal return on his capital investment, because earnings of a close corporation, as is well known, are distributed in major part in salaries, bonuses and retirement benefits.”

Id. (citation omitted) (footnote omitted) (quoting In re Kemp & Beatley, Inc., 473 N.E.2d 1173, 1178 (N.Y. 1984)); see Muellerberg v. Bikon Corp., 669 A.2d 1382, 1385 (N.J. 1996) ("Often times . . . [shareholders in close corporations] consist of family members or friends whose participation in the business is their principal source of employment and income."); Balvik v. Sylvester, 411 N.W.2d 383, 386 (N.D. 1987) (“Employment by the [close] corporation is often the
pants... often look to the corporation for a means of livelihood through payment of salaries or dividends." As a natural consequence, participants in close corporations may also be vulnerable because of their dependence on the benefits and insurance policies that these entities may offer.

If the LLC is a small business which also acts as the economic lifeline of the non-member, the non-member assignee could be as vulnerable as the minority shareholder in a close corporation. In such an LLC, the unanimity voting obstacle presented by state law may be extremely detrimental to the non-member. Without the power to vote and to manage the LLC, the assignee cannot influence LLC affairs. As a result, the assignee may not be able to protect her own economic investment in the LLC. Under current law, this possibility may be mitigated by states adopting the simple majority voting threshold found in Revenue Procedure 95-10. On the other hand, if states follow the Proposed Rules' lead in adopting transferability, the assignee may not encounter this problem.

In the small business/close corporation setting, the participants may be novices. "'[M]any participants in closely held corporations are 'little people,' unsophisticated in business and financial matters.'" "'As minority participants in a close corporation may not anticipate dissension or oppression, and indeed may be unaware of their vulnerability, they frequently fail to bargain for adequate protection against mistreatment.'" Where the assignee of an LLC interest is a novice, she may

shareholder's principal or sole source of income.

45. LEWIS D. SOLOMON & ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXPLANATIONS 206 (2d ed. 1994); see Balvik, 411 N.W.2d at 386 ("Earnings of a close corporation, often are distributed in major part in salaries, bonuses and retirement benefits... ").

46. See generally infra notes 227-29 and accompanying text (discussing the necessity of extending fiduciary responsibilities and other standard of care protections to include non-members because of the dependent nature of the vulnerable non-member). See also infra notes 52-55 and accompanying text (regarding protections needed for minority shareholders).

47. See generally infra part V.D (discussing lack of transfer of voting rights in assignment to non-member assignee); see also supra note 9 (noting that unanimous consent of members is required for transfer of full membership interest in LLC to non-member assignee in 44 of the 49 present LLC statutes).

48. See Rev. Proc. 95-10 § 5.02(2), 1995-1 C.B. 501, 504 (requiring "consent of not less than a majority of the non-transferring members").


50. Id. (quoting O'Neal, supra note 49, at 881).
also encounter identical problems that minority shareholders of a close corporation face.

Another parallel between these two entities is the lack of a primary or a secondary market for the minority investor to escape oppressive actions by the majority-in-interest in each of these respective entities. Based on the common dynamics between close corporations and LLCs, the inflexibility present in close corporations would analogously burden and decrease both the options and the potential solutions offered to a non-member assignee who owns an economic interest in an LLC.

Additional tensions arise whenever the majority owner acts in self-interest to the detriment of the minority members of a close corporation. These problems may include management freeze-outs, abuse of majority management powers solely to advance the majority interest at the expense of the minority shareholder, along with many other situations which arise due to the powerlessness of the minority share-

51. SOLOMON AND PALMITER, supra note 45, at 206. Close corporations have “no ready market for shareholders to dispose of their shares and sometimes [have] contractual limits on transferability.” Additionally, perhaps the most significant difference [between shareholders of public corporations and] . . . close corporation shareholders is the limited range of options available if they become disenfranchised with the way the corporation is being run or how they are being treated. In a public corporation, disenfranchised shareholders have access to reasonably efficient and nearly costless securities markets, such as the New York Stock Exchange, where they can sell their shares—a privilege often called the “Wall Street rule.” As a practical matter, this option is unavailable to close corporation shareholders.

52. See Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663-64 (Mass. 1976) (holding that without a legitimate business purpose, the majority interest violated its fiduciary duty when the majority squeezed out the minority shareholder in a close corporation); Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 515 (Mass. 1975) (“[S]tockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another.” (footnotes omitted)); Cardullo v. Landau, 105 N.E.2d 843, 845 (Mass. 1952) (partners owe each other a duty of “utmost good faith and loyalty”); see also Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 801-02 (Mass. App. Ct. 1981) (holding that in a close corporation, where a minority interest is able to exercise a veto power over the majority in interest, the minority party becomes an ad hoc controlling interest, owing the same fiduciary duties that a majority interest would ordinarily owe the minority interests).

53. See, e.g., Meiselman v. Meiselman, 307 S.E.2d 551, 571 (N.C. 1983) (forbidding one brother who was the majority shareholder and manager of the family close corporation from using his voting power to dismiss his brother, who was the minority shareholder).

54. See, e.g., Alaska Plastics, Inc. v. Coppock, 621 P.2d 270, 277 (Alaska 1980) (noting that denial of benefits to one shareholder that had been accorded to the majority shareholding directors violated duty of equal treatment and equal opportunity owed by board of directors to all shareholders).
holder.55 Because assignees in LLCs are more vulnerable56 and resemble minority shareholders in close corporations, the LLC could experience similar problems. Therefore, the states’ current stance on the virtual non-transferability of voting rights57 might exacerbate the plight of the assignee, who is deprived of the shield provided by voting and management powers which accompany full membership.

IV. SCENARIO 1: REPLACEMENT OF THE RESEMBLANCE TEST WITH THE PROPOSED RULES

A. Introduction

At the time of publication of this Note, the IRS has moved closer towards realizing the initial changes regarding entity classification for federal tax purposes as originally outlined by Notice 95-14.58 With the promulgation of a set of Proposed Rules59 patterned on both Notice 95-14 and the resulting comments,60 the IRS has simplified entity classification for federal tax purposes.61 The IRS “proposes to revise §§ 301.7701-1 through 301.7701-3 of the Procedure and Administration

55. Muellenberg v. Bikon Corp., 669 A.2d 1382, 1386 (N.J. 1996) (“The controlling shareholders' voting power enables them to freeze-out minority shareholders by terminating their employment, excluding them from participation in management decision-making, and reducing their salary and other income.”); Meiselman, 307 S.E.2d at 558-59 (noting that voting power can be used by the majority shareholder as a weapon against the minority shareholder).

56. Because non-members have not even reached the status of a minority member, non-members will not receive the benefits of membership, which include the power to vote and to bind the LLC. See infra part V.D. Therefore, the non-member of an LLC is more vulnerable than the minority shareholder of a close corporation, who is explicitly protected by fiduciary obligations. For cases supporting minority shareholders’ protection under the common law fiduciary concept, see supra notes 52-55.

57. See supra note 9 (listing states’ voting requirements that must be satisfied before an assignee will receive full membership rights).

58. IRS Notice 95-14, 1995-1 C.B. 297.


60. See id.

On April 3, 1995, Notice 95-14, relating to classification of business organizations under section 7701, was published in the Internal Revenue Bulletin (1995-1 C.B. 297). . . . Written comments were received and a public hearing was held . . . . After consideration of the comments, the Treasury Department and the IRS propose to replace the existing classification regulations with a simplified regime that is elective for certain business organizations.

Id.

61. Id. (“These proposed regulations simplify the existing classification rules.”).
Regulations (26 CFR part 301) to clarify which organizations are classified as corporations automatically under the Internal Revenue Code . . . and to provide a simple elective regime for classifying other business organizations.62

If adopted in its present form,63 the Proposed Rules will eliminate the formalistic64 and anachronistic65 Resemblance Test.66 In addition to simplifying determination of the federal tax status of an entity, the Proposed Rules also strive to decrease the inefficient misallocation of resources in small businesses that struggle in order to gain a favorable tax status under the present tax regime.67

Compared with the explicit non-transferability rule as announced in

62. Id.
63. "The regulations are proposed to apply generally for periods beginning on or after the date the final regulations are published in the Federal Register. Sections 301.7701-1 through 301.7701-3 will continue to apply until these regulations are effective." Id. at 21,993 (emphasis omitted). As of September 28, 1996, the Proposed Rules have yet to be finalized in the Federal Register.
64. The formalistic classification system that is presently in effect is relatively simple to circumvent under modern state statutes that offer greater flexibility. Id. at 21,990. "One consequence of the increased flexibility under local law in forming a partnership or other unincorporated business organization is that taxpayers generally can achieve partnership tax classification for a nonpublicly traded organization that, in all meaningful respects, is virtually indistinguishable from a corporation." Id.
65. The IRS recognizes that the present entity classification, or Resemblance Test, has become outmoded.

The existing regulations for classifying business organizations as associations (which are taxable as corporations under section 7701(a)(3)) or as partnerships under section 7701(a)(2) are based on the historical differences under local law between partnerships and corporations. However, many states have revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that traditionally have been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships under local law.

. . . .

In light of these developments, Treasury and the IRS believe that it is appropriate to replace the increasingly formalistic rules under the current regulations with a much simpler approach that generally is elective. To further simplify this area, the proposed regulations provide similar rules for organizations that have a single owner.

Id. at 21,989-90.
66. See generally infra part V (describing and discussing the Resemblance Test that has been used to determine an entity's classification for federal tax purposes under current law, or Scenario 2).
67. In order to fulfill the formalistic rules to gain a favorable tax treatment of an entity under the present classification system, a small business may squander resources that it cannot afford. Id. at 21,990. "To accomplish [a favorable classification] . . . taxpayers and the IRS must expend considerable resources on classification issues. . . . Meanwhile, small business organizations may lack the resources and expertise to achieve the tax classification they want under the current classification regulations." Id.
Revenue Ruling 88-76, the Proposed Rules' silence implicitly consents to free transferability from a member to an assignee. Under Revenue Ruling 88-76, an assignee must receive unanimous support from the non-assigning members before she may become a full member who is eligible to vote and voice her concerns in the LLC's affairs. This unanimity requirement was then relaxed in Revenue Procedure 95-10. According to this rule, the required threshold for an assignee to gain full membership in an LLC was lowered to a majority vote of the remaining LLC members. The Proposed Rules no longer view transferability as an integral element that must be satisfied before an entity receives a favorable partnership classification for federal tax purposes. Instead, the transferability prong from the original Resemblance Test has been eliminated from the proposed entity classification test for federal tax purposes. Therefore, the Proposed Rules are consistent with the ongoing trend that has evolved during the past eight years that favors greater flexibility in the context of transferability.

B. Proposed Changes to Treasury Regulations

Sections 301.7701-1 to 301.7701-3

Under section 301.7701-1 of the Proposed Rules, "[t]he first step in the classification process is to determine whether there is a separate entity for federal tax purposes (which is a matter of federal tax law)." According to section 301.7701-1(a)(1), federal tax law, and not local law, is dispositive as to "[w]hether an organization is an entity separate from its owners for federal tax purposes." Once an organization is classified as a separate entity, it will be treated either as a trust or as a business

69. See id. at 361; see also supra note 9 (listing states' default provisions in LLC statutes and their consent levels required to transfer management rights to an assignee).
70. Rev. Proc. 95-10, 1995-1 C.B. 501; see also William E. Sider, Partnership Taxation—What's Hot and What's Not, 74 Mich. B.J. 1034, 1035 (1995) (characterizing Rev. Proc. 95-10's transferability rules as "pro-taxpayer"); see Hamill, supra note 20, at 589 ("[W]ith the release of Revenue Procedure 95-10... LLCs [are granted] almost as much flexibility as is accorded to limited partnerships... ").
73. Id. at 21,990.
74. Id. at 21,994.
entity for federal tax purposes under proposed sections 301.7701-2, 301.7701-3, and 301.7701-4.

Assuming that the organization's management is separate from its ownership for federal tax purposes, the entity classification test may then proceed to Proposed Rule section 301.7701-2. This section "specifies those business entities that automatically are classified as corporations for federal tax purposes." These business entities qualify for association taxation as long as the organization does not satisfy the trust classification rules as outlined in Proposed Rule section 301.7701-4. If an organization is not a trust, "[a] business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership."

If the entity is not mandatorily treated either as a corporation or as a trust, the business entity is an eligible entity that has discretionary, or elective powers, to select its federal tax status under Proposed Rule section 301.7701-3. This section "provide[s] that a business entity with at least two members can [elect to] be classified as either a partnership or an association." The Proposed Rules further simplify the entity federal tax classification system by providing that tax status "elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an

75. Id. at 21,990.
76. Id. at 21,995.
77. Id. at 21,996-97.
78. Id. at 21,997.
79. Id. at 21,990. In general, [the proposed regulations clarify that business entities that are classified as corporations for federal tax purposes include corporations denominated as such under applicable law, as well as associations, joint-stock companies, insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, organizations that are taxable as corporations under a provision of the Code other than section 7701(a)(3), and certain organizations formed under the laws of a foreign jurisdiction or a U.S. possession, territory, or commonwealth.

Id.
80. Id. at 21,995 (citing Proposed Rule § 301.7701-2(a)).
81. Id. at 21,997.
82. Id. at 21,995 (citing Proposed Rule § 301.7701-2(a)).
83. An eligible entity is a business that is not a per se corporation as defined under Proposed Rule §§ 301.7701-2(b)(1), (3)-(8). "An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership . . . ." 61 Fed. Reg. 21,996 (citing Proposed Rule § 301.7701-3(a)).
84. See 61 Fed. Reg. 21,990.
85. Id.
eligible entity chooses to change its classification."

The Proposed Rules permit domestic eligible entities to automatically default into a partnership tax classification whenever the entity has two or more members. Proposed section 301.7701-3(c) outlines the procedure that applies to eligible entities that wish either to avoid the partnership default tax status or decide to change its present classification. If a new eligible entity elects to change its status, then "it cannot change its classification by election again during the sixty months succeeding the effective date of the election." Finally, Proposed Rule section 301.7701-4 governs the tax status of an organization that is a trust for federal tax purposes.

86. Id. at 21,996 (citing Proposed Rule § 301.7701-3(a), referring to Proposed Rules §§ 301.7701-3(b), (c)).

87. "The proposed regulations are designed to provide most eligible entities with the classification they would choose without requiring them to file an election. Thus, the proposed regulations provide default classification rules that aim to match expectations. An eligible entity that wants the default classification need[s] not file an election." Id. at 21,992.

88. "The proposed regulations define the term partnership to include any business entity that has at least two members and that is not classified as a corporation." Id. at 21,991.

89. Id. at 21,996 (citing Proposed Rule § 301.7701-3(b)(1)(i)). "Thus, a newly formed domestic eligible entity will be classified as a partnership if it has two or more members unless an election is filed to classify the entity as an association; no affirmative action need be taken by the entity to ensure partnership classification." Id. at 21,992.

90. "An eligible entity may elect its classification by filing an election with the appropriate service center." Id.

91. Id. at 21,996 (citing Proposed Rule § 301.7701-3(c)).

92. "The proposed regulations require that an election be signed by: (1) Each member of the entity, or (2) any officer, manager, or owner who is authorized to make the election and who represents to having such authorization under penalties of perjury." Id. at 21,993.

93. Id. at 21,996 (citing Proposed Rule § 301.7701-3(c)(1)(ii)).

94. Because a trust classification for federal tax purposes is beyond the scope of this Note, the specific amendments and changes may be further researched at 61 Fed. Reg. 21,997 for more information pertaining to Proposed Rule § 301.7701-4.
V. SCENARIO 2: LIMITED LIABILITY COMPANY MECHANICS AND THE RESEMBLANCE TEST: DETERMINATION OF ENTITY TYPE FOR FEDERAL INCOME TAX PURPOSES

Because LLCs are unincorporated business entities, the LLC may be classified for federal income tax purposes as either a partnership or as an association taxable as a corporation. Partnerships are "pass through" entities that are taxed once because income "flow[s] through to individual partners." On the other hand, as associations for federal income tax purposes, corporations are taxed twice. Therefore, an LLC must be classified as a partnership for federal tax purposes in order to realize the beneficial tax status offered by partnerships.

95. As of the writing of this Note, the Proposed Rules are currently under study. See supra note 63. Therefore, the Resemblance Test, as modified by Rev. Proc. 95-10, is the current law. Rev. Proc. 95-10, 1995-1 C.B. 501, 502-03. This Note examines the Resemblance Test both before and after the promulgation of Rev. Proc. 95-10.

A Revenue Procedure describes the steps that a taxpayer must satisfy before she could "obtain[] an advance ruling as to whether an LLC will be taxed as a partnership." Gerald F. Stack, Recent Developments Concerning Limited Liability Companies, 67 N.Y. St. B.J. 50, Sept./Oct. 1995, at 50. Additionally, Rev. Proc. 95-10 only sets forth the standards which must be met in order to obtain a favorable ruling from the [IRS] that the LLC will be classified as a partnership. It is not a statement of the substantive law in this area. Nonetheless, the careful practitioner will want to stay within the safe harbor of Rev. Proc. 95-10.

96. LEFKOWITZ & AKSELRAD, supra note 14, § 1.4.1. In determining the tax status of an entity, the IRS may also tax an entity as a trust. Treas. Reg. § 301.7701-2(n)(1) (as amended in 1993); see also Schmalz & Starr, supra note 29, at 260 ("Because the [Internal Revenue] Code does not refer directly to LLCs, these entities must be put in one of the other pigeonholes—corporation, partnership, or trust—to determine their tax status.").


98. Id. Double taxation results from the income that is taxed both at the corporate level and as income distributed by the corporation to the corporation's investors. Id. [As a] taxable entity . . . [a corporation] pays tax . . . before making any 'distribution' of money or property to its owners. The receipt of the distribution by the owner of a taxable entity is, in turn, income to the owner which the owner must report on its own tax return. Thus, the income of a taxable entity [such as a corporation that is treated as an association] is taxed twice.

99. "Limited liability companies are primarily formed in order to obtain pass-through tax status." Macey, supra note 97, at 442. "One of the primary attractions to the LLC as a choice of business organization is the pass-through taxation treatment." Spainhour, supra note 36, at 34.

As a result of being classified as a pass-through entity, the LLC members will be liable for allocations of "income, gain, or loss [which] passes through to the . . . members to be reported on
In order to determine whether or not an LLC will be taxed as a partnership for federal tax purposes, an attorney or the IRS will test the LLC for its corporate or partnership characteristics. If the LLC resembles a corporation, then the LLC will not receive the beneficial partnership tax status. The current entity test, or Resemblance Test, has the following four elements: (1) continuity of life, (2) centralized management, (3) limited liability, and (4) free transferability of interests. A partnership for federal tax purposes will have either one or two of the previous elements. An entity will be taxed as a corporation if it has either three or four of these characteristics. In distinguishing between corporations and partnerships for federal tax purposes,
the IRS will weigh each of these elements equally. Revenue Procedure 95-10 provides "specific ruling standards and indicates continued IRS acceptance of partnership tax treatment for LLCs [through the continued use of the Resemblance Test]."  

A. Continuity of Life

1. Before Revenue Procedure 95-10

Several factors or events are considered in determining whether an entity lacks the corporate characteristic of continuity of life. Under the Procedure and Administration Regulations, "if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist." Under federal tax regulation, the operating agreement may permit the remaining members to continue the business "in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization." Therefore, an LLC may be continued by the remaining members despite being dissolved, while simultaneously avoiding the corporate characteristic of continuity of life.

Dissolution may also be triggered by any of the following: when a specified event occurs, after passage of a certain amount of time, by the submission of written consent by the members, or by a judicial de-

106. Larson, 66 T.C. at 172 (holding that each prong from Morrissey, 296 U.S. at 359, will be weighed equally). The court in Larson held that the limited partnership in question was a partnership for federal tax purposes while possessing both free transferability and centralized management, but lacking continuity of life and limited liability. Id. at 185.

107. Barbara C. Spudis, LLCs: Recent Developments and the Developing Uses of Hybrid LLCs, in 3 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS 1995, at 1003, 1022 (PLI Tax Law and Practice Course Handbook Series No. J-373, 1995). See generally Ribstein, supra note 2 (arguing that although Revenue Procedure 95-10 provides much needed guidance, some new problems have been created).

108. A dissolution occurs whenever there is "a change in the relationship between [an organization's] members as determined under local law." Treas. Reg. § 301.7701-2(b)(2). This section also states that a dissolution results when a partner leaves a general partnership, which then destroys the agency relationships between the departing partner and the general partnership. Id.

109. Id. § 301.7701-2(b)(1).

110. Id. § 301.7701-2(b)(2).

111. Id.

Whenever a member has the individual power to dissolve the organization, the entity will lack continuity of life. The existence of such an involuntary dissolution of the LLC will avoid the corporate continuity of life determination. Additionally, continuity of life does not exist if consent by a majority vote (or greater) is required by the remaining majority in interest partners in order to avoid dissolution.

In light of the LLC's goals, the founding member(s) may prefer to require a unanimous vote by the remaining members in interest after the occurrence of one of the above dissolution events. This policy choice will increase the difficulty of extending the LLC's life after the death, insanity, bankruptcy, retirement, resignation, expulsion of any member or any of the other above-specified incidents which will cause dissolution of the organization. Therefore, the founding member(s) of an LLC may avoid continuity of life by creating a requirement which is higher than the majority-vote threshold of the remaining members in interest for the perpetuation of the LLC's lifespan.

On the other hand, the LLC may preserve its continuity while avoiding such a corporate classification by "imposing on each member a contractual obligation to exercise the right to continue the company upon dissolution." Simultaneously, the articles of organization could require unanimous consent from the members while limiting "the available remedies for breach of the obligation [to continue the company upon dissolution] to money damages and not specific performance." Therefore, a member may not have sufficient incentive to vote to dissolve the LLC, while simultaneously maintaining the lack of continuity of life label which is necessary for a partnership classification.

113. See Miller, supra note 3, at 35-36 n.28.
115. Miller, supra note 3, at 24 n.3.
117. Upon creation of an LLC, the founding member(s) may define the voting requirement (i.e., majority or even unanimity of the remaining members in interest, depending on the LLC's goals and policies), in connection with continuity of life in the operating agreement.
118. See Treas. Reg. § 301.7701-2(b)(1).
120. McLaughlin, supra note 119, at 237.
121. Id.
2. Changes After Revenue Procedure 95-10

If the LLC elects or appoints member-managers, and either the controlling statute or operating agreement "provides that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member-manager causes a dissolution of the LLC without further action of the members," the IRS will generally rule that the LLC lacks continuity of life if consent to continue the LLC must come from "not less than a majority in interest of the remaining members." Under section 5.01(2), the same majority in interest consent rule applies to LLCs that "do not designate or elect one or more members as managers." Both sections 5.01(1) and 5.01(2) require that the list of dissolution events must apply to every member-manager, or member, respectively. Additionally, "the IRS will not rule that the LLC lacks continuity of life unless the taxpayer clearly establishes . . . that the event or events selected provide a meaningful possibility of dissolution."127

123. Id.
124. As used in Revenue Procedure 95-10, majority in interest was defined in an earlier promulgation by the IRS. See Rev. Proc. 94-46, 1994-2 C.B. 688 (holding that the "majority in interest" requirement "will be satisfied if remaining [members] owning a majority of the profits interests and a majority of the capital interests owned by all the remaining [members] agree to continue the [enterprise]"). New York has a similar definition of majority in interest. See supra note 9.
126. In order for a dissolution event to be meaningful, the member-manager should be an individual. Because a corporate-manager in an LLC cannot die, any dissolution event that is so predicated is impossible, which violates the "meaningful possibility of dissolution" requirement found in Rev. Proc. 95-10 § 5.01(4), 1995-1 C.B. 501, 502-03. See Stack, supra note 95, at 51; see also Hamill, supra note 20, at 593 n.126 ("The IRS has indicated informally that a meaningful possibility of dissolution requires that a legal possibility, but not necessarily a factual possibility, must exist."); Schmalz & Starr, supra note 29, at 263 ("Rev. Proc. 95-10 adopts a stricter continuity-of-life standard for LLC ruling purposes . . . ").
B. Centralized Management

1. Before Revenue Procedure 95-10

LLCs generally may choose from several management models.128 Some states permit a prorated division of management powers129 based on each member's proportional capital contribution ("Proportional Management").130 "Assuming no agreement to the contrary is included in the articles of organization, these LLCs will lack the corporate characteristic of centralized management."131

If the jurisdiction offers a flexible LLC statute, either an LLC's operating agreement may opt for management of the entity by all members ("Member Management" or "Member Management Model"), or the statute itself may provide Member Management as a default provision. Under this regime, each individual LLC member may bind the LLC. Member Management parallels the general partnership's diffuse management structure in which powers are vested equally in every partner of the partnership. In a general partnership, each individual partner has the power to single-handedly manage and to bind the partnership.132 Because the member-managed LLC will also possess limited liability, the LLC may wish to adopt the corporate quality of continuity of life. For reasons discussed below,133 the LLC will usually be unable to include the corporate feature of free transferability of interest.

Most states' default management provisions opt for the Member Management Model.134 An LLC's management structure will depend on the operating agreement’s choice of either centralized management or member management. Spainhour, supra note 36, at 36; see Miller, supra note 3, at 24 n.3 ("Depending on the actual organization[al] structure of a limited liability company, it may also be possible for the entity to lack centralized management . . . ." (citation omitted). Additionally, "[a]n operating or management agreement governs business operations and relationships among members of a limited liability company." Id. at 25-26.

128. An LLC's management structure will depend on the operating agreement's choice of either centralized management or member management. Spainhour, supra note 36, at 36; see Miller, supra note 3, at 24 n.3 ("Depending on the actual organization[al] structure of a limited liability company, it may also be possible for the entity to lack centralized management . . . ." (citation omitted). Additionally, "[a]n operating or management agreement governs business operations and relationships among members of a limited liability company." Id. at 25-26.

129. This proportional representation concept is "more similar to the corporate theory of 'one share one vote' than to the partnership theory of 'one partner one vote.'" Geu, supra note 32, at 63.


131. McLaughlin, supra note 119, at 239. "[I]t is unclear how the [IRS] would view a situation where the managing members owned more than twenty percent of the LLC's interest." Id. at 240.

132. See UNIF. PARTNERSHIP ACT § 18(e) (1914) (superseded by UNIF. PARTNERSHIP ACT § 401(f) (1994)).

133. See infra text accompanying notes 195-99.
Management Model. Because LLCs face the same problems that close corporations encounter, management structure may either strengthen or weaken the minority member. By consolidating management in a handful of members, the minority interests are further delegated to the outer fringes of power. This additional segregation of the minority member further weakens her security and increases her vulnerability. This problem parallels the non-member assignee's voiceless property interest in an LLC. Because the non-member cannot vote or manage the LLC, the non-member is left to the mercy of her LLC colleagues.

This result highlights the problem with the states' current stance that voting rights cannot be freely alienated directly from the member assignor to the non-member assignee. Therefore, states requiring unanimity of consent should permit the right to vote and manage to transfer automatically to the non-member assignee. Without this power, the non-member may only have recourse via a judicial solution, which is both after the fact and may have been fully avoidable had the states adopted a freer transfer of voting and management rights default standard.

The third LLC management model is analogous to a corporation's centralized management ("Centralized Management" or "Centralized Management Model") structure. An entity has Centralized Manage-

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134. See, e.g., N.Y. LTD. LIAB. CO. LAW § 401(a) (McKinney 1995) ("Unless the articles of organization provides for management of the limited liability company by a manager or managers or a class or classes of managers, management of the limited liability company shall be vested in its members . . . ").

135. See supra part III.

136. For example, adopting either Member Management or Proportional Management may benefit the minority member much more than an LLC which selects the Centralized Management Model.

137. See ALA. CODE § 10-12-22 commentary (Supp. 1994):

The emerging limited liability company model adopted by most limited liability company statutes calls for management directly by the members. This is based on several important factors. First, because limited liability company interests are not freely transferable, members who are dissatisfied with their investments must resort to active involvement rather than simply exiting the firm as investors in [a] public corporation can.

Id.

138. See supra part III.

139. See, e.g., N.Y. LTD. LIAB. CO. LAW § 603(a)(2) (McKinney 1995) ("Except as provided in the operating agreement, . . . an assignment of a membership interest does not . . . entitle the assignee to participate in the management and affairs of the limited liability company or . . . to exercise any rights or powers of a member . . . . ").

140. "The existence of managers somewhat complicates the statutory scheme because it bifurcates the management function from ownership and, at least to some extent, provides for
ment whenever a sub-group of the whole organization has the sole and exclusive power to "make the management decisions necessary to the conduct of the business for which the organization was formed." Managers may also be non-members who are either elected for a term or automatically reappointed. The method of appointing management is irrelevant to the centralized management prong as long as the effect of the appointment is to concentrate exclusive managerial power in an individual or group which controls the LLC. In addition to being independent of the members, management cannot act as mere agents administering the principals’ demands. Therefore, individuals who have management powers in an LLC with Centralized Management "resemble in powers and functions the directors of a statutory corporation."

2. Changes After Revenue Procedure 95-10

A key change is Revenue Procedure 95-10’s “emphasis on the distinction between manager-managed and member-managed LLCs.” If the LLC “is managed by the members exclusively in their membership capacity, the [IRS] generally will rule that the LLC lacks centralized management.”

The IRS will rule that centralized management exists whenever the

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143. Moreover, the [LLC] members have the flexibility to follow the partnership model and designate managers who, like a general partner of a limited partnership, may serve in such capacity for an indefinite period of time, or to follow the corporate model and provide for election, removal and replacement of managers on an annual or other basis. [This may be provided by private] operating agreements.
145. Treas. Reg. § 301.7701-2(c)(2).
146. Id. § 301.7701-2(c)(3).
147. Id. § 301.7701-2(c)(1).
148. For an interesting discussion and examination of potential problems introduced by Revenue Procedure 95-10 regarding the management distinction, see Ribstein, supra note 2, at 39-41.
149. This new focus materially affects free transferability. See infra part V.D.
elected or designated member-managers (as a group) own less than twenty percent of the interests of the LLC.\footnote{Id. § 5.03(2), 1995-1 C.B. at 504; see also Schmalz & Starr, supra note 29, at 262 ("A major development in Rev. Proc. 95-10 is its adoption of a special rule in Reg. 301.7701-2(c)(4), which ... provides that a limited partnership has centralized management if substantially all the interests in the partnership are owned by limited partners.").} However, "even if the aggregate ownership requirement is satisfied, the [IRS] will consider ... member control of the member-managers (whether direct or indirect), in determining whether the LLC lacks centralized management."\footnote{Rev. Proc. 95-10 § 5.03(2), 1995-1 C.B. 501, 504.} Furthermore, the IRS may rule that Centralized Management exists "if the member-managers are subject to periodic elections by the members or, alternatively, if the non-managing members have a substantially unrestricted power to remove the member-manager."\footnote{Schmalz & Starr, supra note 29, at 262.} It seems that "nonmanagers' control over the manager indicates representative—and therefore centralized—management."\footnote{Id. at 260.}

C. Limited Liability

1. Before Revenue Procedure 95-10

Limited liability is the main corporate characteristic that LLCs strive to achieve.\footnote{The IRS has summarily dismissed this corporate characteristic [from the Resemblance Test when determining whether an entity is an association taxable as either a corporation or as a partnership for federal income tax purposes] because members of an LLC will undoubtedly be held to have limited liability, since limited liability is one of the primary reasons for forming an LLC. Spainhour, supra note 36, at 36; see Rev. Rul. 93-38, 1993-1 C.B. 233, 235 (pertaining to a Delaware LLC); Rev. Rul. 93-6, 1993-1 C.B. 229, 231 (pertaining to a Colorado LLC); Rev. Rul. 93-5, 1993-1 C.B. 227, 229 (pertaining to a Virginia LLC); Rev. Rul. 88-76, 1988-2 C.B. 360, 361 (pertaining to a Wyoming LLC). "[L]imited liability companies offer limited liability as a matter of course ...." Macey, supra note 97, at 435; see Geu, supra note 98, at 503 ("[L]imited liability is one of the centerpieces of LLC design."); Sylvester J. Orsi, Comment, The Limited Liability Company: An Organizational Alternative for Small Business, 70 Neb. L. Rev. 150, 174 (1991) ("[I]t appears quite clear that an LLC will always possess limited liability for purposes of federal income tax classification.").} This element protects an entity's members from liability for "the debts of or claims against the organization [under local law]."\footnote{Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993). Under this section, "a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim." Id.} Similar to corporations, LLC members are only liable for the
initial amount that was invested in the entity.\textsuperscript{156}

2. Changes After Revenue Procedure 95-10

In order for an LLC to obtain a ruling that it lacks limited liability, a member, or members, must assume "personal liability for all (but not less than all) obligations of the LLC, pursuant to express authority granted in the controlling statute."\textsuperscript{157} The assuming members are required to own an aggregate net worth of at least ten percent of total contributions both at the time of the ruling request and throughout the LLC's existence.\textsuperscript{158} The IRS will apply close scrutiny if the assuming members do not satisfy the ten percent safe-harbor threshold.\textsuperscript{159} The assuming member, or members, could overcome the close scrutiny if the member has "substantial assets\textsuperscript{160} (other than the member's interest in the LLC) that could be reached by a creditor of the LLC."\textsuperscript{161}

D. Free Transferability of Interests

1. Before Revenue Procedure 95-10

For an entity to have

the corporate characteristic of free transferability of interests . . . each of its members or those members owning substantially all\textsuperscript{162} of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must

\textsuperscript{156} McLaughlin, supra note 119, at 241 ("The owners' liability is restricted to their investment in the entity."). On the other hand, a member will still be responsible for personally malignant or negligent acts. See, e.g., N.Y. LTD. LIAB. CO. LAW § 420 (McKinney 1995) (providing that LLC members will not be shielded by limited liability if their "acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action . . . or . . . that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled").

\textsuperscript{157} Rev. Proc. 95-10 § 5.04, 1995-1 C.B. 501, 504.

\textsuperscript{158} Id. § 5.04, 1995-1 C.B. at 504-05.

\textsuperscript{159} Id. § 5.04, 1995-1 C.B. at 505.

\textsuperscript{160} The assuming member's net worth will be calculated pursuant to the criteria set forth in § 4.03 of Rev. Proc. 92-88, 1992-2 C.B. 496. Rev. Proc. 95-10 § 5.04, 1995-1 C.B. 501, 505.

\textsuperscript{161} Rev. Proc. 95-10 § 5.04, 1995-1 C.B. 501, 505.

\textsuperscript{162} See Rev. Proc. 92-33, 1992-1 C.B. 782, 782 (holding that although "substantially all" depends on facts and circumstances surrounding a particular organization, "a[n] [organization] lacks free transferability of interests if . . . the [operating] agreement expressly restricts . . . the transferability of [organization] interests representing more than 20 percent of all interests in . . . capital, income, gain, loss, deduction, and credit").
be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization.\textsuperscript{163}

A member's interest in an LLC has two components. First, the member's investment entitles her to share in the LLC's fortunes and losses. Second, investment in the LLC may also entitle the member to vote and to manage the LLC.\textsuperscript{164} Therefore, substitution,\textsuperscript{165} or full transferability, exists only when the member assignor is able to transfer unilaterally her full interest in both the profits and her managerial powers to a non-member assignee without initially obtaining consent from the remaining LLC members.\textsuperscript{166} If a member only transfers to an assignee the right to receive profits from the LLC, the LLC does not retain the free transferability characteristic because the assignee is neither substituted for the assignor nor enfranchised by the second prong of membership, which grants a full member the power to manage or to vote.\textsuperscript{167} Because the assignee does not receive the entire bundle of property rights, there is no free transferability.\textsuperscript{168} In such a case, the

\begin{itemize}
  \item \textsuperscript{163} Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993).
  \item \textsuperscript{164} This assumes the LLC has adopted the Member Management Model, and not a Centralized Management Model.
  \item \textsuperscript{165} See Treas. Reg. § 301.7701-2(e)(1) (describing the requirements for the substitution of members); Orsi, \textit{supra} note 154, at 174 ("[S]ubstitution refers to a complete transfer of all the attributes of the member's interest in the organization, not merely a right to share in the profits." (footnote omitted)).
  \item \textsuperscript{166} See Treas. Reg. § 301.7701-2(e)(1) ("Thus, the characteristic of free transferability of interests does not exist in a case in which each member can, without the consent of other members, assign only his right to share in profits but cannot so assign his rights to participate in the management of the organization.").
  \item \textsuperscript{167} Having managerial power may be very important in the context of an LLC. LLCs tend to be small entities, \textit{see supra} note 3, due to a lack of transferability. \textit{See} Miller, \textit{supra} note 3, at 68 ("An investment in a limited liability company lacks liquidity to the extent that there is no public market to dispose of the interest."). As a result of this lack of transferability, LLCs are deprived of the opportunity to raise large amounts of capital through the market system. Because of the relatively small size of LLCs, combined with the lack of transferability and non-existence of a freely accessible marketplace, many of the standard of care problems and fiduciary issues that majority interests in small corporations confront resurface in the LLC context. Orsi, \textit{supra} note 154, at 161 (noting that because of potential conflict of interests between the majority and the minority members, the minority members may be vulnerable to freeze-outs and other problems which may be mitigated by imposing a "standard of utmost good faith and loyalty often used in both the partnership and close corporation settings"). Therefore, voting and management rights provide an extra layer of protection for the minority LLC member in addition to the fiduciary concept. For a parallel discussion favoring free transfer of voting and management rights, see \textit{infra} part VI.B.
  \item \textsuperscript{168} This partial transfer of property rights from an LLC member to the non-member assignee parallels transfers in a general partnership. \textit{See} Geu, \textit{supra} note 32, at 79.
  \item The assignment of an interest in the partnership does not, however, transfer any of the partner's management rights in the partnership . . . even though the assignee is entitled
\end{itemize}
assignor may retain her voting rights despite having assigned her rights
to share in the LLC's profits to the assignee. Therefore, by pattern-
ing LLC law on general partnership law under the Uniform Partnership
model, the member assignor may expect to retain her residual voting and
management rights while the non-member assignee receives the right
to share in the profits and losses of the LLC. As a result of the non-
transferability of management rights, the LLC is able to ensure that the
partnership characteristic of non-transferability for federal income tax
purposes is maintained under Scenario 2. In essence, such a tax status
election conflicts with the general consent requirements found in most
state LLC statutes.

On the other hand, under the Revised Uniform Limited Partnership
Act, a transfer of a partner’s entire interest to a non-member terminates
the assignor’s partner status in the partnership, except for the
partner’s original obligations. Once again, the assignee may become
a limited partner only if the limited partners unanimously consent to
substitution of this new limited partner to the limited partnership.
Additionally, there is “no free transferability of interest if under local law
a transfer of a member’s interest results in the dissolution of the
LLC.”

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169. See Geu, supra note 32, at 79 (citing UNIF. PARTNERSHIP ACT § 29 (1914) (superseded
by UNIF. PARTNERSHIP ACT § 801 et seq. (1994))) (“Indeed, the assigning partner remains a partner
in spite of the assignment . . . .”); Spainhour, supra note 36, at 37 (citing Priv. Ltr. Rul. 91-19-029
Priv. Ltr. Rul. 89-37-010 (June 16, 1989)).

170. See supra note 9 and accompanying text.

171. REVISED UNIF. LIMITED PARTNERSHIP ACT § 702 (1985).

172. REVISED UNIF. LIMITED PARTNERSHIP ACT §§ 502(b)-(c), 704(c).

173. REVISED UNIF. LIMITED PARTNERSHIP ACT § 704(a)(ii). It is also possible for the assignee
to become a limited partner if the assignor was accorded the authority to assign such a right
explicitly in the partnership agreement. Id. § 704(a)(i).

The IRS has also considered modified free transferability.\textsuperscript{175} In effect, before a member is able to transfer her interest in the LLC to a non-member assignee, the remaining LLC members have a right of first refusal\textsuperscript{176} before the assignor is permitted to sell to an outside non-member.\textsuperscript{177} This initial offering to members within the LLC must be based on fair market value.\textsuperscript{178} "In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form."\textsuperscript{179}

2. Changes After Revenue Procedure 95-10

Significant changes announced in Revenue Procedure 95-10 concern the free transferability prong.\textsuperscript{180} Although Revenue Procedure 95-10 divides free transferability into either centrally-managed LLCs or member-managed LLCs, the consent rules governing transferability are facially parallel with the potential for significantly different impacts.

a. Centrally-Managed LLC

If an LLC is managed by elected or appointed member-managers and the controlling statute or operating agreement "provides that each member, or those members owning more than 20 percent of all interests in the LLC’s capital, income, gain, loss, deduction, and credit"\textsuperscript{181} need at least "a majority of the non-transferring member-managers"\textsuperscript{182} consent in order to convey full membership rights to the assignee, the IRS will usually rule that the LLC lacks free transferability of interests.\textsuperscript{183}

Several implications flow from the above rule. Up to seventy-nine percent of the LLC may be freely transferable, while simultaneously

\textsuperscript{175} See id. § 301.7701-2(e)(2).
\textsuperscript{176} That is, a member has the first opportunity to purchase or "to meet terms of [the] proposed contract before it is executed." BLACK’S LAW DICTIONARY 1325 (6th ed. 1990).
\textsuperscript{177} Treas. Reg. § 301.7701-2(e)(2).
\textsuperscript{178} Id.
\textsuperscript{179} Id.
\textsuperscript{180} See Spudis, supra note 107, at 1028-29 (raising the possibility that Revenue Procedure 95-10 decreases the burden regarding transfers that substitute the assignee in lieu of the assignor).
\textsuperscript{181} Rev. Proc. 95-10 § 5.02(1), 1995-1 C.B. 501, 504.
\textsuperscript{182} Id.
\textsuperscript{183} Id.; see also Schmalz & Starr, supra note 29, at 263 ("[T]he existence of centralized management depends on a concentration of the legal right to manage . . . .").
retaining the non-transferability prong for federal income tax purposes.\textsuperscript{184} Not only has the consent requirement been reduced from unanimity to a simple majority, the required consent is only needed from a majority of the member-managers, which is much more lenient than the former unanimity requirement of consent from all members of the LLC. “The combination of [these two factors] . . . allows LLCs the same flexibility enjoyed by limited partnerships. LLCs can lack free transferability on a technical basis, yet retain the business advantages of minimal transferability restrictions.”\textsuperscript{185} On the other hand, this liberalization of transferability is tempered by the “meaningful restriction” requirement, or the existence of a member’s power to withhold consent to the proposed transfer.\textsuperscript{186}

b. Member-Managed LLC

In a member-managed LLC, the same consent threshold applies as found in the centrally-managed LLC.\textsuperscript{187} Additionally, the same implications, as discussed earlier, would also flow from this rule. On the other hand, the consent requirement may be somewhat higher and more restrictive because “consent of not less than a majority of the non-transferring members”\textsuperscript{188} is required. The preceding conclusion assumes that member-managed LLCs would have a greater number of “voters” than in the centrally-managed LLC. Thus, because an assignee would most likely need the consent from fewer elected or appointed member-managers than from a vote that would be considered by all the non-transferring members of an LLC, section 5.02(2) may effectively decrease the ease of transferability. Therefore, it is arguable that an assignee in a member-managed LLC may have greater difficulty in becoming a full member than an assignee who seeks membership in a centrally-managed LLC.

According to section 5.02(3), which applies to both centrally-managed and member-managed LLCs, “consent of a majority includes either a majority in interest, a majority of either the capital or profits interests in the LLC, or a majority determined on a per capita basis.”\textsuperscript{189} Again, the IRS requires that meaningful consent, or the ability to

\textsuperscript{184} See infra note 191.
\textsuperscript{185} Hamill, supra note 20, at 597.
\textsuperscript{186} See Rev. Proc. 95-10 § 5.02(4), 1995-1 C.B. 501, 504.
\textsuperscript{187} See id. § 5.02(2), 1995-1 C.B. at 504.
\textsuperscript{188} Id. (emphasis added).
\textsuperscript{189} Id. § 5.02(3), 1995-1 C.B. at 504 (citation omitted).
"withhold consent to the transfer . . . of the interests"190 must exist before the IRS will rule that an LLC lacks free transferability for federal income tax purposes.

VI. POTENTIAL SOLUTIONS

A. Rewriting the States' Transferability Standards

In light of all the above problems that LLCs share with close corporations, a reasonable argument could be made that states with restrictive default provisions should adopt either the IRS' free transferability stance under the Proposed Rules or a simple majority stance from Notice 95-10. Either approach will then increase the ease of gaining full membership. In turn, this relatively liberal standard may mitigate some of the potential problems resulting from an assignee's inability to manage and to vote in an LLC.

A new default consent standard may decrease further the effects of the assignee's lack of voting power. Ideally, free transferability could solve the assignee's voting rights and management problem. This possible solution is a further extension of Revenue Procedure 95-10's majority requirement, which also permits up to seventy-nine percent of an LLC's interests to be freely transferred without violating the non-transferability prong.191 Additionally, full membership rights upon transfer will also be consistent with the layperson's expectations.192

In order to retain the non-transferability element under current law (Scenario 2), states may alter their present transfer requirements before an assignor is permitted to assign her full interest in an LLC to a non-

190. Id. § 5.02(4), 1995-1 C.B. at 504.
191. Under present law, the LLC could potentially permit up to 79% of its interests to be fully transferred or substituted while simultaneously retaining the non-transferability prong of the Resemblance Test. See Rev. Proc. 95-10 § 5.02(1), (2), 1995-1 C.B. 501, 504 (noting that whenever 20% or more of all the interests cannot confer full membership rights on an assignee, the LLC will lack free transferability of interests). Therefore, the Notice actually permits much greater transferability of interests than the facial majority rule. See Stack, supra note 95, at 51.
192. See supra part I.
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member. For instance, states with inflexible statutes may reverse their current position regarding the admission of an assignee into full membership. Under the present system, the assignee's membership status depends upon receiving sufficient consent from the remaining members. In the new scenario, before an assignee could become a full member empowered with both voting and membership rights, a majority\(^\text{193}\) of the remaining members in interest of the LLC, excluding the assignor, generally must consent to the assignor's proposed assignment to this individual assignee. This reversal could work well whenever there is hostility between the assignor and the remaining members. In such a situation, the remaining members would probably support the assignor's request for an assignment of interest. Such a reversal switches the non-transferability burden from the assignee to the member. In doing so, this new requirement may satisfy the non-transferability prong for federal income tax purposes,\(^\text{194}\) while simultaneously granting the direct transfer of voting rights from the assignor to the formerly non-member assignee, who would then become a full member, because she will have the right to vote and to manage the LLC. This reversal also implies that the remaining members' approval of the assignment also inherently ratifies the new member's legitimacy and standing to manage and to work within the LLC. Admittedly, this would be a complete reversal of the IRS stance under Revenue Procedure 95-10, which only permits the non-member assignee to receive her voting and management rights if a majority of the members vote to approve this grant of power. That is, the assignor could transfer her rights to share in monetary gains and losses without effectively depriving the assignee the power to vote and to manage, which then enables the assignee to protect her interest and investment in the LLC.

B. Possible Planning: Crafting Limited Liability Companies to Maximize Protection of the Non-Member Assignee Under Current Law

Perusal of the four individual elements of the Resemblance Test under Scenario 2 leads the practitioner to conclude that the LLC can only

\(^{193}\) See generally supra part V.D.2 (discussing Notice 95-10's flexible definition of majority).
\(^{194}\) See generally supra part V (discussing four-part Resemblance Test used to determine the tax status of a business entity).
select one of the remaining three elements, because it is virtually\textsuperscript{195} established by definition that the LLC will retain the corporate characteristic of limited liability.\textsuperscript{196} Of the three remaining elements, centralized management is probably the most desirable.\textsuperscript{197} In light of the managerial problems and liability ramifications which arise from the diffusion of management power analyzed under the agency and respondeat superior theories of ordinary partnerships, a middle-sized or large LLC could benefit vastly by retaining the corporate trait of centralized management.\textsuperscript{198} Thus, the LLC will generally have neither continuity of life nor free transferability of interests under state law in order to preserve the beneficial partnership tax classification under Scenario 2.\textsuperscript{199} Some states permit the nascent LLC the freedom to select from any one of the remaining corporate characteristics.\textsuperscript{200} Selection of a “favorite” corpo-

195. See, e.g., N.Y. LTD. LIAB. CO. LAW § 609(b).


198. Macey, supra note 97, at 437 n.21 (“[A]ny firm of significant size will have centralized management.”).

199. Miller, supra note 3, at 24 n.3 (“Most limited liability company acts are drafted so that a limited liability company will fail the corporate classification test by lacking continuity of life and free transferability of interests,” (citation omitted); see Macey, supra note 97, at 435. (“[T]he Internal Revenue Service has clearly stated that it will grant partnership (i.e., pass-through) tax status to limited liability companies as long as they do not possess the corporate characteristics of continuity of life and free transferability of interests.” (citing Rev. Rul. 88-76, 1988-2 C.B. 360, 361)).

200. See Geu, supra note 98, at 502 (“[U]nder some state statutes there may be room for choosing which of the two [remaining] corporate characteristics to ‘fail.’”).
rate characteristic will depend on the individual LLC’s goals, policies underpinning the operating agreement, and possibly the members’ or managements’ goals. On the other hand, the less flexible LLC acts are “bulletproof” in the sense that the state legislature has predetermined which corporate characteristics the LLC will retain from the Resemblance Test, thereby precluding any freedom of choice for the businessperson who is filing with the state that has a bulletproof statute. As discussed below, the promoter may avoid a bulletproof statute by filing her LLC documents with a state that offers a more flexible, and therefore more favorable, LLC statute.

Despite offering many benefits, a member’s interest in an LLC is essentially non-transferable under current state law. This characteristic must be retained in most states before the entity will be classified as an LLC.

On the other hand, one can construct a flexible LLC which partially mitigates both the problems and the deleterious effects associated with the inflexibility that accompanies the non-transferability of a member’s interest found in most LLC statutes. Before filing with the secretary of
state or department of state to create an LLC, the LLC organizer must define clearly the LLC's goals, which, more likely than not, will then be reflected in the operating agreement. In defining the purpose of the LLC, one factor that the organizer will consider is the importance of whether or not the LLC should maximize flexibility in terms of transferring member interests from a member assignor to a non-member assignee. Selecting relatively free transferability of membership interests might provide a starting point of issues and solutions to examine which may aid practitioners and their clients in achieving this goal while simultaneously protecting the non-member assignee.

method of raising additional capital. For a parallel of this concept which exists in the limited partnership context, see Geu, supra note 32, at 82-83 ("The relative ease of admitting new limited partners is important for the business planner to consider when choosing an entity because it gives the limited partnership a more practical equity alternative to debt for future financing."). Thus, another incidental benefit that such a model LLC might offer through easing the transfer of voting and management rights to an assignee may be the creation of a more beneficial method of raising capital for the LLC by facilitating the entry of new members.

Although some organizers may prefer restricted transferability in a small business, the organizer may still increase the initial flexibility of transferring membership interests to prepare against future contingencies. The main caveat is that while the organizer may want to maximize the individual member's power to transfer her interests, this flexibility must be tempered in order to preserve the LLC's beneficial tax status under Scenario 2. She must carefully weigh and balance these two factors to insure retaining the partnership characteristic of non-transferability for federal income tax purposes. Because greater flexibility could improve the planner's options in light of future problems, states should adopt either the more liberal approach found in the Proposed Rules, or in Rev. Proc. 95-10 § 5.02(1), (2), 1995-1 C.B. 501, 504. For further discussion regarding entity classification for federal income tax purposes under Scenario 2, see supra part V.

208. LLCs are statutory creatures that are created by filing articles of organization with the department of state or secretary of state. See, e.g., CONN. GEN. STAT. ANN. § 34-123 (West Supp. 1995) ("A limited liability company is formed when the articles of organization are delivered to the secretary of state for filing and endorsed by the secretary of state ...."); N.Y. LTD. LIAB. CO. LAW § 203(d) (McKinney Supp. 1996) ("A limited liability company is formed at the time of the filing of the initial articles of organization with the department of state ....").

209. In most states, the operating agreement is a document which governs virtually all aspects of a limited liability company. The operating agreement "relates to (i) the business of the limited liability company, (ii) the conduct of its affairs and (iii) the rights, powers, preferences, limitations or responsibilities of its members, managers, employees or agents, as the case may be." N.Y. LTD. LIAB. CO. LAW § 417 (McKinney 1995).

This plan is similar to a corporation's by-laws or a limited partnership’s limited partnership agreement. See Miller, supra note 3, at 25-26 ("An operating or management agreement governs business operations and relationships among members of a limited liability company."). See also Geu, supra note 32, at 62 (noting that a partnership agreement in a limited partnership is analogous to the by-laws in a corporation).

210. For a definition of “full” membership interest see supra text accompanying notes 14-16. See generally supra part V.D (discussing transferability of interests in LLCs under Scenario 2).

211. Some states offer greater flexibility than others regarding transferability. See supra text accompanying notes 195-203 (contrasting bulletproof and flexible LLC statutes). By understanding the variations between the states’ LLC acts, the practitioner may shop between states in order to best
The current Resemblance Test presents complex and unnecessary planning problems. While increasing the ability to transfer member interests to assignees, a practitioner must carefully craft the LLC to retain sufficient factors\textsuperscript{212} to maintain the essential non-transferability characteristic of partnerships for federal income tax purposes.\textsuperscript{213} If the new LLC is classified\textsuperscript{214} by the IRS as an association which possesses the corporate characteristic of free transferability, the entity will be both penalized severely\textsuperscript{215} and treated as a corporation for federal income tax purposes,\textsuperscript{216} which could effectively frustrate one of the initial goals in the creation of the LLC.\textsuperscript{217}

Additional factors affect the freedom of transfer from a member assignor to a non-member assignee. Understanding these factors helps us to build a paradigm for LLCs that mitigates the harshness of non-transferability for the non-member assignee under present state laws that deny flexible transfers.\textsuperscript{218}

An important initial distinction is differentiating between flexible

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\textsuperscript{212}Upon finalization of the Proposed Rules, the entity classification function of the Resemblance Test will become moot because the Proposed Rules would permit taxpayers to default into a partnership classification for federal income tax purposes where the entity is eligible. \textit{See supra} notes 63 and 95. Adoption of the Proposed Rules will not eliminate the transferability quandary that presently exists due to the states' non-transferability stance. \textit{See supra} notes 16-23 and accompanying text.

\textsuperscript{213}\textit{See discussion supra} part V.A-D.

\textsuperscript{214}Again, this scenario assumes that the Proposed Rules have not yet been finalized.

\textsuperscript{215}\textit{See LEFKOWITZ \& AKSELRAD, supra} note 14, § 1.4.2.

\textsuperscript{216}\textit{See generally supra} part V (discussing four-part Resemblance Test used to determine the tax status of a business entity).

\textsuperscript{217}This scenario assumes that the LLC planner relied on a partnership classification of the non-transferability prong. For example, an LLC which initially elected the corporate characteristics of limited liability and centralized management would be classified as a partnership if the LLC possessed no other corporate characteristics. If the planner inadvertently caused the LLC to possess free transferability in addition to the two previous characteristics, then the LLC would be treated as a corporation for federal income tax purposes. Such a result would penalize the LLC. \textit{See supra} note 215.

\textsuperscript{218}\textit{See supra} note 9 (describing consent requirements of default provisions of various LLC statutes).
and bulletproof statutes. In general, if the statute is flexible and not "bulletproof," the state may favor both greater latitude and discretion for the LLC and the membership. As a corollary, the organizer also has the freedom to shop for the most favorable LLC statute and then file the LLC's documents with a state that provides the most flexibility in transferring interests for members of an LLC. On the other

219. Most LLC acts permit the LLC to opt out of the default solutions offered by the state LLC statute. See, e.g., N.Y. LTD. LIAB. CO. LAW § 202 (McKinney Supp. 1996) (permitting a New York LLC to adopt articles of organization which displace the default provisions provided by the state LLC statute). See supra note 201. In such flexible states, members of the LLC have the opportunity to contract privately to abide by terms which have been specially tailored in the operating agreement, instead of being governed by the default provisions of the state’s LLC act. As a result, some potential pitfalls may arise.

Because of the dichotomies which will arise between the state’s default requirements and provisions within the private operating agreement, the LLC planner is presented with a potential opportunity to exploit in order to increase flexibility of transferring her membership interest to non-member assignees. On the other hand, the planner also may be ambushed by problems of interpretation. If a state requires unanimous consent by the remaining members before an assignee can become fully enfranchised as a member with management rights, an LLC’s lack of free transferability classification may be jeopardized by an operating agreement which lowers the consent threshold to a simple majority. At the moment, the law in this area is very murky. Although both the Proposed Rules and Revenue Procedure 95-10 may provide LLC members with some persuasive support for the liberalization of the voting requirement, see Rev. Proc. 95-10 § 5.02(1), (2), 1995-1 C.B. 501, 504, state law nonetheless would prevail.

One possible solution to this problem may be to require consent that exceeds a simple majority. A supermajority approaching two-thirds or even three-quarters of the remaining members may circumvent the unanimity requirement in some states. As the voting threshold requirement approaches unanimity in the operating agreement, the chances increase of satisfying inflexible default provisions of state LLC statutes that require unanimity. Additionally, this increased consent requirement also reflects the problems created by the Resemblance Test. Thus, an LLC may be able to increase transferability of member interests to a lesser degree by availing itself of the opportunity to contract out of the state’s default statutory provisions regarding non-transferability. Although this results in less flexibility than offered by Revenue Procedure 95-10, see id., the planner who files in a state that requires unanimous consent must otherwise abide by the state’s inflexible transfer provision.

220. States provide that an LLC may opt out of the default provision requiring unanimous consent. See, e.g., CAL. CORP. CODE § 17303(a) (West Supp. 1995) (“Except as otherwise provided in the articles of organization or the operating agreement, an assignee of an interest in a limited liability company may become a member only if the other members unanimously vote in favor of the assignee’s admission . . . .” (emphasis added)). But see supra note 201 and accompanying text (noting that bulletproof statutes allow for less flexibility in structuring the LLC).

221. “[J]urisdictional competition for limited liability company charters, similar to the competition for general corporate charters that Delaware currently leads, could develop as states vie with each other for the chartering fees associated with the formation of limited liability companies.” Macey, supra note 97, at 441; see infra notes 222 and 226.

222. See Sider, supra note 70, at 1035 (discussing how the enactment of a bulletproof statute, while achieving the desired goal of ensuring tax classification of LLCs as a partnership, may force LLC organizers to shop for out-of-state, non-bulletproof statutes where flexibility in the ability to transfer interests is desired). See generally Macey, supra note 97, at 447 (discussing the role of
hand, a “bulletproof” statute may indicate a state’s aversion to LLC flexibility.22

Before selecting which state to file in the creation of an LLC, the promoter may be able to increase the ease of transferring a member’s interest by understanding the differences between in-state and out-of-state LLC statutes. By knowing the advantages and the weaknesses of each statute, the practitioner may carefully select the state’s LLC law which is most favorable to her client’s goals. For example, if the client prefers flexibility of transfer, the attorney would avoid bulletproof statutes.22

In effect, the different degrees of flexibility among the statutes fosters LLC statutory forum shopping.2

A third factor that affects freedom of transferability is reflected by the standard of care that may exist between LLC members and their management.227 By adopting a higher standard of due care between members and management within an LLC, the operating agreement may provide greater protection for the LLC member. This concept may be expanded to apply to non-member assignees as well. If the statute that governs the LLC does not already define the standard of care among the members, the operating agreement of a model LLC may specifically

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223. See supra part V.D.
224. See generally supra note 9 (listing LLC statutes and their voting requirements).
225. See supra note 201 and accompanying text (discussing how the bulletproof statutes ensure beneficial tax classification while flexible statutes may permit greater free transferability of LLC interests).
226. See Macey, supra note 97, at 447.
227. See Miller, supra note 3, at 32 (arguing that the standard of conduct concepts from agency, partnership and contractual principles should apply between members and managers in LLCs in order to protect “historically abused minority and passive owners”). Professor Miller argues that the higher standard of due care prescribed by agency law should govern relationships between members and management. Id. at 74, 82-83. “A standard of due care applicable to all members would foster the reciprocal responsibility owed by majority and minority members toward each other.” Id. at 75. Agency law’s standard of due care, or negligence standard, between members and managers is a “more socially responsible legal standard of care [than is the partnership standard of gross negligence].” Id. at 78. This higher standard of care may counteract the tendency of LLC members to act more carelessly or recklessly, which results from the lack of personal liability offered by an LLC. Id. at 77.
extend the due care protection in such a manner that members and managers would owe the same fiduciary duty to the non-member assignee as the members and managers would normally owe to each other. Thus, the operating agreement may be drafted to protect the presently voiceless non-member assignee. This is another possible shield which decreases the damage that the non-transferability of voting rights inadvertently creates for the non-member assignee in an LLC that is a small business.

Along the same fiduciary duty vein, an operating agreement in a flexible LLC may include a provision which would not permit a member to act in any way that violates her duty of loyalty to any of her fellow members and non-members. As a result of such an agreement, the member may be prohibited from acting in ways that may injure the non-member assignee.229

A fourth opportunity that exists for the planner to increase free transferability is inherent in the selection of a management structure for the LLC. Because Revenue Procedure 95-10 permits consent from a simple majority of member-managers in a centrally-managed LLC, the Revenue Procedure greatly increases the LLC's free transferability, while simultaneously preserving this prong for federal income tax purposes under Scenario 2.230 Instead of requiring majority consent from the membership, the assignee only needs a majority vote of approval from the member-managers. The planner must keep in mind that this IRS

228. The protective thrust that underpins the fiduciary duty concept was eloquently set forth by Judge Benjamin Cardozo in Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

Id. (citation omitted).

229. For example, if a hostile outsider has explicitly stated that she would like to buy a controlling interest in an LLC in order to achieve a goal which may be detrimental to either the membership or the non-member assignee, the contractual protection offered by the operating agreement in this case may cover both the member and the non-member assignees. Therefore, the majority in interest member may not be able to transfer her interest to the hostile “vulture” due to the contractual fiduciary obligations imposed by the operating agreement.

230. See supra part V.D.2 (discussing the free transferability prong after the changes as announced in Revenue Procedure 95-10).
position on majority consent may conflict with an in-state unanimity requirement. Therefore, the planner may have sufficient incentive to shop for a more favorable LLC statute.\textsuperscript{231}

In summary, choice of state law may increase transferability of interests,\textsuperscript{232} thereby possibly further shielding the non-member assignee. Additionally, an operating agreement may be crafted to avoid the default legal "settings" provided by the in-state LLC statute by opting out of the state’s requirements and agreeing to be governed solely by the private contractual terms of the operating agreement.\textsuperscript{233} Examining and understanding the fiduciary obligations and relationships that exist in close corporations may lead to drafting an operating agreement in a flexible LLC that protects non-member assignees by selecting a due care standard. Finally, selection of a centrally-managed LLC may increase free transferability because of Revenue Procedure 95-10’s lower majority consent threshold. Therefore, an attorney may carefully weigh and balance each of the above competing elements in light of the flexible LLC’s goal of maximizing transferability, while simultaneously retaining the required partnership characteristic of non-transferability\textsuperscript{234} and protecting the non-member assignee during the planning stage of a future LLC.

VII. CONCLUSION

In summary, several themes, or currents, flow in support of the conclusion that states with inflexible transfer default provisions\textsuperscript{235} should amend their LLC statutes in a manner which facilitates\textsuperscript{236} the transfer of a full membership interest to an assignee. As a result, state law will then meet and conform with the small businessperson’s reasonable expectation that she will be able to protect her investment and actively manage and vote in the LLC.\textsuperscript{237}

In addition to satisfying the assignees’ goals and expectations, such an easing of state default provisions will also be consistent with the federal government’s trend towards facilitating transfers to assignees.

\begin{itemize}
\item \textsuperscript{231} See supra notes 221, 222 and 226.
\item \textsuperscript{232} See supra text accompanying notes 221, 222 and 226.
\item \textsuperscript{233} See supra note 220 and accompanying text.
\item \textsuperscript{234} See supra part V.D.
\item \textsuperscript{235} See supra note 9.
\item \textsuperscript{236} See generally supra part VI.A (suggesting revision of default provisions of state LLC statutes).
\item \textsuperscript{237} See supra part I.
\end{itemize}
Initially, the IRS’ transfer standard basically prevented the full transfer of membership interests by requiring unanimous consent from the remaining LLC members.238 State laws then followed suit. Afterwards, this strict standard was lowered by Revenue Procedure 95-10.239 Not only did 95-10 permit a majority vote from an LLC’s members to be sufficient, but this Revenue Procedure also permitted a majority vote of managers to be sufficient to bestow full membership powers upon the assignee.240 Additionally, if a planner chose, she could elect to permit the LLC to have free transferability approaching seventy-nine percent of an LLC’s interests.241 In effect, the Proposed Rules have lifted the twenty-one percent restriction as imposed by Revenue Procedure 95-10.242

Although the preceding chronology reflects how transferability has metamorphosed for federal income tax purposes, the states that currently retain the unanimity requirement243 are clearly behind the current curve, or trend that facilitates transfers of membership interests.

By juxtaposing an assignee of LLC interests in a small business with a minority shareholder of close corporations, it becomes apparent that an assignee will experience similar difficulties that her counterpart will encounter in protecting her investment in the small business.244 Therefore, easing state default transfer provisions of LLC statutes will mitigate the problems that these assignees in small businesses presently confront.

Finally, comparisons between the Proposed Rules (Scenario 1)245 and the Resemblance Test (Scenario 2)246 serve to highlight the difficulties created by the latter approach. In addition to easing transferability, the Proposed Rules also protect the small businessperson’s reasonable expectations of active involvement with the small business.

States that currently require unanimous consent before an assignee

238. See supra notes 8, 68-69, 199 and accompanying text.
240. See supra part V.D.2.a.
241. Id.
242. Id.
243. See supra note 9.
244. See supra part III.
245. See supra part IV.
246. See supra part V.
gains a full membership interest in an LLC should either lower or eliminate this outmoded prerequisite.

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