

SENATE BILL REPORT

2SHB 1235

AS REPORTED BY COMMITTEE ON LAW & JUSTICE, FEBRUARY 22, 1994

Brief Description: Creating partnerships.

SPONSORS: House Committee on Judiciary (originally sponsored by Representatives Appelwick, Padden, Ludwig and Johanson)

HOUSE COMMITTEE ON JUDICIARY

SENATE COMMITTEE ON LAW & JUSTICE

Majority Report: Do pass as amended.

Signed by Senators A. Smith, Chairman; Ludwig, Vice Chairman; Hargrove, Nelson, Quigley, Roach, Schow and Spanel.

Staff: Jon Carlson (786-7459)

Hearing Dates: February 21, 1994; February 22, 1994

BACKGROUND:

Business organizations in the state of Washington have three general organizational forms to choose from: (1) corporate, codified in RCW Chapter 23B; (2) limited partnership, codified in RCW Chapter 25.10; and (3) general partnership. Each of these forms has unique characteristics which distinguish them and give rise to their advantages and disadvantages.

Corporations are created when articles of incorporation are filed with the Secretary of State. Corporate existence is perpetual regardless of what happens to shareholders, directors, or officers. Corporations have centralized management consisting of: a board of directors that supervises management; officers that carry out the policies of the board of directors; and shareholders who may have no active role in management except electing the board of directors and other specified matters. Generally, corporate shares are freely transferable, and shareholders are liable for corporate debts and obligations only to the extent of their investment in the corporation. Corporations are treated as taxable entities.

A general partnership is created whenever two or more persons create an association to carry on business and share in profits and ownership control. No legal documentation is required to form a partnership, and the partnership dissolves upon the death, bankruptcy or withdrawal of any partner, unless otherwise agreed. Each partner is an agent of all others and can bind the partnership. Ordinary partnership matters are decided by a majority vote of the partners. Partners cannot transfer their interests in the partnership unless all other partners agree. Each partner has unlimited

personal liability for the debts and obligations of the partnership, and the partnership is treated as a flow-through entity for taxation purposes.

Limited partnerships consist of general partners and limited partners. General partners run the business and are fully liable for the partnership's debts and obligations. Limited partners are liable only to the extent of their contributions, as long as they do not participate in control of the business. Limited partnerships are formed when a document is filed with the Secretary of State, and it exists for as long as the parties agree or until a general partner withdraws. General partners have the authority to bind the partnership, and limited partners have voting authority over specified matters. The interests of general partners cannot be transferred unless all general and limited partners agree, while limited partners' interests are freely assignable. Limited partnerships are not taxed at the entity level unless they are operated like a corporation.

One of the major differences between corporations and general and limited partnerships relates to tax treatment. Corporations are taxed at the entity level, resulting in double taxation for all earnings distributed to shareholders. General partnerships are not taxable entities. All profits and losses flow through to the partners who must pay taxes. Limited partnerships are treated like general partnerships for tax purposes unless the limited partnership operates like a corporation. There are four factors the Internal Revenue Service uses to distinguish a corporation from a partnership for tax purposes: (1) continuity of life; (2) centralized management; (3) limited liability; and (4) transferability of ownership interests. An organization will be treated as a corporation for tax purposes if it has more corporate than noncorporate characteristics.

Another important distinction between corporations and partnerships concerns the liability of owners. Corporate shareholders are liable only to the extent of their investment in the corporation, although courts may "pierce the corporate veil" and impose personal liability on shareholders in special circumstances. Under Washington case law, piercing may occur if a corporation has been intentionally used to violate or evade a duty owed to another and the piercing is necessary to prevent unjustified loss to an injured party. Meisel v. M & N Modern Hydraulic Press Co., 97 Wn.2d 403 (1982). In contrast, all partners in a general partnership, and at least one partner in a limited partnership, are subject to personal liability for any of the partnership's debts or obligations.

Recently, the limited liability company has developed as an alternative form of organizing a business. The limited liability company combines the tax advantages of a partnership with the limited liability advantages of a corporation. The limited liability company is a noncorporate entity which allows the owners to actively participate in management and provides them with limited liability. The limited liability company is not taxed at the entity level because of

limitations on transferability of interests, limited existence, and the possibility of owner management.

Wyoming first enacted a limited liability company statute in 1977, followed shortly thereafter by Florida in 1982. No more states enacted limited liability company statutes until 1990 when the Internal Revenue Service ruled that a Wyoming limited liability company would be treated as a partnership for tax purposes. The Internal Revenue Service stated that the lack of personal liability would not preclude classifying an entity as a partnership for tax purposes. In response to this favorable ruling, several states began considering legislation in this area. Currently more than 35 states have enacted limited liability company statutes.

SUMMARY:

The act authorizes the formation of a new type of business in Washington, the limited liability company.

GENERAL PROVISIONS: Definitions of many terms related to limited liability companies are provided. "Limited liability company" is defined as any company organized and existing under this chapter. "Foreign limited liability company" is defined as an unincorporated entity organized under the laws of another state or foreign country which affords the members of the entity limited liability with respect to the entity's liabilities. "Limited liability company agreement" is defined as "any written agreement as to the affairs of a limited liability company and the conduct of its business which is binding upon all of the members."

Rules concerning the naming of limited liability companies are provided, along with detailed rules concerning maintenance of a registered office and registered agent to receive service of process.

The powers of a limited liability company include any lawful business or activity except for banking or insurance. The powers of a limited liability company can be restricted in the limited liability company agreement.

A limited liability company agreement may eliminate or limit the personal liability of a member or manager to the limited liability company or its members. This limitation on liability may cover monetary damages for conduct as a member or manager. It may also provide for indemnification of members or managers from and against any judgments, settlements, penalties, fines or expenses incurred in a proceeding to which a member or manager is a party because of the status of being a member or manager. The company agreement may not provide limited liability or indemnification of members or managers for acts or omissions involving intentional misconduct or involving a knowing violation of the law for certain transactions. Those transactions include ones from which the member or manager will personally receive a benefit to which the member or manager is not legally entitled, ones involving distributions that cause the limited

liability company to be unable to pay its debts, or ones for distributions made when other liabilities exceed the assets of the limited liability company. The doctrine of piercing the veil is expressly made applicable to limited liability companies in situations analogous to those in which it applies to corporations.

The duties and liabilities of members or managers may be expanded or restricted in the limited liability company agreement, and members or managers are not liable to the limited liability company or other members or managers for good faith reliance on the provisions of the limited liability company agreement.

The formation of limited liability companies to render professional services is generally allowed. Members of a professional limited liability company may include a professional corporation or another professional limited liability company, if the shareholders and officers of the corporation, or the members of the limited liability company, are licensed to render the same specific professional services. Professional service limited liability companies may include out-of-state members so long as managers in this state and all members practicing in this state are licensed in this state. Members of a professional service limited liability company are personally liable to the extent the company fails to maintain professional liability insurance of \$1 million, or such greater amount as the state insurance commissioner may set.

FORMATION: A limited liability company is formed when a certificate of formation is filed with the Secretary of State. The certificate of formation must vest management in one or more managers if the limited liability company is not to be managed by the members. Detailed procedures for the formation, execution, amendment, or cancellation of the certificate of formation are provided.

Limited liability companies are required to file annual reports with the Secretary of State in a manner equivalent to the reports required of corporations.

MEMBERS: Classes or groups of members and voting requirements by class may be established in the company agreement. Unless the company agreement provides otherwise, actions requiring member approval require the affirmative vote of members contributing, or required to contribute, 50 percent of the agreed value of the contributions made, or required to be made, by all members. A unanimous vote is required, unless otherwise provided in the company agreement, for amending the company agreement, or authorizing a member or manager to act outside the company agreement.

The debts, obligations, and liabilities of the limited liability company, whether arising from tort or contract, are solely the debts, obligations, and liabilities of the limited liability company, and no member or manager is personally liable solely by reason of being a member or manager. A

member or manager is liable for his or her own tortious conduct.

A detailed list of events of dissociation is provided, including the withdrawal of a member, the assignment of all of a member's interest, or the removal of a member. The company agreement can provide for any other events which result in a person ceasing to be a member.

The following records and information must be kept at the principal place of business and subject to inspection and copying by reasonable request by any member during ordinary business hours: certificate of formation, company agreement and amendments, statement of contributions made and to be made by all members, distribution rights, tax returns and financial statements for three years.

MANAGEMENT: Management of the limited liability company is vested in the members unless the certificate of formation provides otherwise. The company agreement may restrict or enlarge the management rights and duties of members as managers. Unless otherwise provided in the company agreement, managers are selected by the affirmative vote of members contributing, or required to contribute, 50 percent or more of the agreed value of the contributions made or to be made. If the certificate of formation vests management in managers, a member cannot act as an agent of the limited liability company.

Unless otherwise provided in the company agreement, members and managers are not liable in damages or otherwise to the limited liability company or its members for any act or omission unless such act or omission constitutes gross negligence, intentional misconduct, or a knowing violation of the law. Members and managers must account to the limited liability company for any profit or benefit derived without the consent of a majority of disinterested members or managers from transactions connected with the conduct or winding up of the limited liability company, or any use of limited liability company property.

Voting by managers requires approval by 50 percent of the number of managers, unless the company agreement allows for voting by class, group, financial interest, or any other basis. The company agreement can provide classes or groups of managers with relative rights, powers, and duties.

Any member or manager is entitled to rely in good faith upon the records of the limited liability company and upon information, opinions, reports or statements presented to the limited liability company by members, managers, officers, employees, or other persons, as to matters the member or manager reasonably believes to be within the person's expert or professional competence.

FINANCE: Member contributions may be in the form of cash, property, services rendered, or promissory note, or other obligation to contribute. Unless otherwise provided in the

company agreement, members are obligated to the limited liability company to perform any promise to contribute cash, property or services, even if unable to because of death, disability, or any other reason. The obligation of a member to make a contribution or return money or property distributed wrongly may be compromised only by consent of all members. However, a creditor who reasonably relied on the obligation in extending credit may enforce the original obligation.

Allocation of profits and losses are made according to company agreement. If the company agreement does not specify the means of allocation, then allocations are made in proportion to the agreed value of contributions made or required by each member.

DISTRIBUTIONS AND RESIGNATION: A member may receive distributions prior to dissociation and dissolution as provided in the company agreement. Upon dissociation, a member is entitled to receive distributions already allocated or the fair value of the member's interest in the limited liability company. Distributions may not be made if they would cause the limited liability company to be unable to pay its debts as they become due or when all liabilities, other than members' allocations, exceed the fair value of the assets of the limited liability company. Members who receive distributions in knowing violation of these restrictions are liable to the limited liability company for the distribution if an action is commenced within three years.

ASSIGNMENT OF LIMITED LIABILITY COMPANY INTERESTS: A member's interest is assignable, except as provided in the company agreement. The assignee is entitled to the same allocations and distributions as the assignor, but has no right to participate in management unless all other members approve or as otherwise provided in the company agreement. Various events constituting an assignment of a member's interest are provided. No liability attaches to an assignee until the assignee becomes a member. An assignee who becomes a member is liable for the obligations of his or her assignor to make contributions.

DISSOLUTION: Events resulting in dissolution of a limited liability company are provided. Upon the winding up of a limited liability company, the assets shall be distributed as follows: (1) to creditors, including members and managers who are creditors, in satisfaction of liabilities; (2) to members in satisfaction of distributions; and (3) to members for contributions, and then for members' interests, in proportion to the members' shares in distributions.

FOREIGN LIMITED LIABILITY COMPANIES: Foreign limited liability companies are required to register with the Secretary of State and maintain a registered office and registered agent. The laws under which a foreign limited liability company is organized govern its organization, internal affairs, and liability of members and managers. Registration cannot be denied because of a difference in those laws.

The failure of a foreign limited liability company to register does not impair the validity of any contract entered into, right of any party to a contract to maintain a suit, or prevent the foreign limited liability company from defending against any suit brought against it, but prevents them from maintaining an action in the courts of the state. Members or managers of foreign limited liability companies are not liable simply by doing business in the state without being registered. A list of activities that are considered "transacting business" is provided.

DERIVATIVE ACTIONS: A member may bring an action on behalf of a limited liability company if managers or members with authority to do so have refused to bring the action, or an effort to cause them to bring an action is not likely to succeed. The member must be a member at the time of bringing the action and at the time of the transaction complained of.

MERGERS' AND DISSENTERS' RIGHTS: A limited liability company may merge with one or more limited partnerships, corporations, or other limited liability companies pursuant to a merger plan. The plan must set forth the names of all merging companies and the surviving company, terms and conditions of merger, and the manner and basis of converting of the interests. Approval of the merger plan requires the affirmative vote of members contributing 50 percent or more of the value of all contributions. Details concerning the filing and effects of merger are provided. Merger of foreign and domestic limited liability companies, limited partnerships, and corporations is allowed.

A member of a limited liability company may dissent from a merger plan and obtain payment of the fair market value of the member's interest in the limited liability company. A dissenter may not challenge a merger unless the merger fails to comply with the procedural requirements imposed by this article, or with the company agreement, or is fraudulent with respect to the member or limited liability company. Detailed rules concerning notice requirements and payment demands are provided.

MISCELLANEOUS PROVISIONS: The rule that statutes in derogation of the common law are to be strictly construed does not apply to this chapter. The policy of the chapter is to give maximum effect to the principle of freedom of contract and the enforceability of limited liability company agreements. The Secretary of State has authority to adopt rules necessary to implement the transfer of duties and records required by this chapter.

The licensing statute for certified public accountants is amended to allow members of that profession to organize as a limited liability company. A similar general provision is made applicable to all other licensed professions.

SUMMARY OF PROPOSED COMMITTEE AMENDMENT:

A technical amendment is made to the definitions section of the bill to correctly reference health care professionals.

Appropriation: none

Revenue: none

Fiscal Note: none requested

Effective Date: October 1, 1994

TESTIMONY FOR:

The bill will encourage growth of new businesses in the state. Most other states are already taking advantage of this new form of business entity.

TESTIMONY AGAINST: None

TESTIFIED: PRO: William Pusch, WA State Bar Association; Sheldon Frankel, WA State Bar Association; Jim Boldt, WA Society of Certified Public Accountants; Larry Shannon, WA State Trial Lawyers Association; Bob Underhill, WA Society of Certified Public Accountants; Linda Mackintosh, Secretary of State's office