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VIRGINIA LIMITED LIABILITY COMPANY ACT

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I. INTRODUCTION

A. Effective Date.


B. Definition.

A limited liability company ("LLC") is "an entity that is an unincorporated association having two or more members that is organized and existing under" the Act. § 13.1-1002.

1. Entity. In view of numerous partnership attributes, it was thought desirable to include specific statement that LLC is an entity.

2. Unincorporated association. IRS requirement.

A stock corporation with a shareholder agreement under § 13.1-671.1 that attempts to eliminate the corporate characteristics of free transferability and continuity of life cannot qualify as a partnership for tax purposes because it is a corporate entity.

3. At least two members - IRS requirement.

* Mr. Donn is Chairman, Joint Committee on Limited Liability Companies of the Virginia Bar Association Sections of Business Law and Taxation; an Official Adviser to the Drafting Committee to Revise the Uniform Partnership Act of the National Conference of Commissioners on Uniform State Laws; Chairman, Joint Ventures and General Partnership Subcommittee of American Bar Association Section of Business Law Partnership Committee; Chairman, Partnership Committee, Virginia Bar Association Business Law Section; Past Chairman, Section of Taxation, Virginia State Bar (1981-83).
4. Members - may be individuals or entities.

"Member" is a "person" that owns an interest in an LLC. § 13.1-1002. "Person" has the meaning specified in the Stock Act. § 13.1-1002. That definition includes individual and entity. § 13.1-603.

5. Organized under the Act. Distinguishes LLC from general partnership, definition of which is similar.

C. Principal Characteristics.

The owners of the entity have the limited liability of the shareholders of a corporation, but the entity is treated as a partnership for federal and Virginia income tax purposes.

D. Sources of the Act.

1. There is no Uniform Act. The drafting committee looked to the Wyoming Act, the only one subject of a favorable revenue ruling and the Colorado Act and the pending Maryland bill as reflecting more modern drafting.

2. Internal Revenue Service requirements for partnership classification.

Rev. Rul. 88-76, 1988-2 C.B. 360, held that an LLC formed under the Wyoming Act would be classified as a partnership. As will be discussed below, that ruling was based upon the conclusion that the entity formed under the Wyoming Act lacked the corporate characteristics of free transferability of interests and continuity of life. A committee of the ABA Tax Law Section met with representatives of IRS on November 8, 1990 for clarification as to the provisions of the Wyoming Act that were deemed essential to its favorable ruling.

3. Virginia Code analogues. Since the LLC has both corporate and partnership features, the Act derives certain of its provisions from the Virginia Stock Corporation Act ("Stock Act") and the Virginia Revised Uniform Limited Partnership Act ("VRULPA"). The Act does not contain a provision comparable to VRULPA § 50-73.75, which would provide that in any case not provided for in the Acts, then some other statute would apply.

E. Drafting Principles.

1. On the issues of transferability of interests and continuity of existence, the Act follows the Wyoming model, which results in mandatory compliance with the requisite partnership tax characteristics, in order to enhance the chances of obtaining a favorable revenue ruling on the Virginia Act, rather than
providing the greater flexibility of the Florida Act, as to which IRS has refused to issue a revenue ruling.

2. The Act adopts the approach of the UPA, which has been described as "to a large extent, a standard form of agreement that can be varied by the parties." 2 Bromberg and Ribstein, Partnership 7:7 (1988).

3. The bill did not include specific conforming amendments to other provisions of the Virginia Code. There was only the "global" provision that wherever the term person is defined to include both "corporation" and "partnership," it shall be deemed to include "limited liability company." § 13.1-1069.

F. Advantages of an LLC Compared With Other Business Entities.

1. S Corporation. Limited liability of shareholders and pass through treatment for tax purposes without the restrictions and consequent tax traps of an S corporation, such as limits on number of owners and eligible owners, 80% limit on ownership of stock of a corporation, and one class of stock. Also, may include entity debt in basis.

2. Limited Partnership. Right of all members to participate in management of the business without risk of the liability to which a limited partner may be subject under similar circumstances.

G. Disadvantages and Risks.

1. Uncertainty as to tax status until ruling by IRS.

2. Lack of flexibility due to provisions on transferability of interest and dissolution.

3. Uncertainty as to the limited liability status of members in states that have not enacted LLC legislation.

4. Absence of experience and developed body of case law.

5. No exception from recordation tax for transfers by members to LLC and by LLC to members.

II. ORGANIZATION

A. Name.

1. The name must contain "limited company" or "L.C." § 13.1012A.
2. The name may not contain words that are required to be included in the name of a corporation or limited partnership. § 13.1-1012B.

B. Governing Documents.

1. Articles of Organization ("Articles"). The document filed to form the LLC. § 13.1-1002.

2. Operating Agreement ("OA"). An agreement of the members as to the affairs of the LLC and the conduct of its business. § 13.1-1002.

C. Purpose of LLC.

Any lawful purpose except:

1. The provision of professional services as defined in § 13.1-543;

NOTE: Even if the LLC form is made available, CPAs will be precluded by AICPA Rule 505, which limits members to practicing in proprietorships, partnerships or professional corporations. In November, 1991 members will vote on a proposed change that would allow them to practice in any form permitted by state law, including an LLC. See Rimerman, The Need for Expanding Organizational Options for CPAs, 172 J. Accountancy, Oct. 1991, p. 45.

2. As otherwise provided by Virginia law; or

3. As limited by the Articles.

§ 13.1-1008
(Source § 13.1-626).

D. Powers.

The same powers as an individual to do all things necessary or convenient to carry out its business and affairs. The Act list of powers is illustrative, not exclusive.

§ 13.1-1009.
(Source § 13.1-627A).

The enumerated powers need not be set forth in the Articles. § 13.1-1011C.
E. Formation.

1. One or more persons may form an LLC by signing and filing Articles with the SCC. That person or persons need not be members. § 13.1-1010.

   NOTE: While one person may perform the formal act of forming the LLC, by definition an LLC must have at least two members.

2. An LLC is created on the date that the SCC issues the certificate of organization. § 13.1-1004B. A certificate will be issued when the SCC finds that the Articles comply with the Act and required fees have been paid. § 13.1-1004A. (Source § 13.1-621).

Like a corporation, LLC existence begins when SCC issues the certificate; unlike a limited partnership which is formed at the time of filing the certificate of limited partnership with the SCC. § 50-73.11B.

F. Form.

SCC has published a form of articles of organization, Form LLC-1011, which may be used. However, it is optional and any document that includes the required information may be used.

G. Contents of the Articles of Organization.

1. Name that satisfies requirements of § 13.1-1012.

2. Name of initial registered agent and address of initial registered office, which must be in Virginia. § 13.1-1015.

   NOTE: Form LLC-1011 contains an affirmation that an individual registered agent is a resident of Virginia. Unlike the Stock Act (§ 13.1-619A.4) and VRULPA (§ 50-73.11.3), which require a statement to that effect, the Act contains no such requirement. Nevertheless, SCC requires the statement and a 1992 amendment to the Act should be anticipated.

3. Principal office, which need not be within Virginia. This is the place at which the records required by § 13.1-1028 are to be kept.

4. Period of its duration. The Act does not contain the 30-year maximum term in the Wyoming Act. However, unlike a corporation (§ 13.1-627), an LLC does not have perpetual duration.
5. Any other matter that is permitted to be set forth in an OA.

   a. A number of sections of the Act prescribe a rule that applies unless "otherwise provided in the articles of organization or an operating agreement." Since Articles and any amendment must be filed with the SCC, generally preferable to "otherwise provide" in the OA.

   b. Act is silent on whether a limitation on authority set forth in the Articles will constitute constructive notice of that limitation. Although the Act does not have a provision like VRULPA § 13.1-73.19, result should be the same, that is, not constructive notice.

§ 13.1-1011 (Source § 50-73.11)

6. Neither names of members nor purpose nor powers need be included.

7. Some statutory rules may be changed only by the Articles.

   a. Majority vote to amendment Articles. § 13.1-1014B.

   b. OA need not be in writing. § 13.1-1023B.1


H. Operating Agreement.

1. The members are authorized to enter into an Operating Agreement to regulate or establish the affairs of the LLC, the conduct of its business, and the relations of its members. § 13.1-1023A.

2. Unless the Articles specifically require otherwise, the OA need not be in writing. § 13.1-1023B.1. However, the Act does require that provisions must be in writing to change certain statutory rules. E.g., § 13.1-1029 (sharing of profits and losses).

3. The OA may contain any provisions regarding the affairs of the LLC and the conduct of its business to the extent not inconsistent with Virginia law or the Articles. § 13.1-1023A.
4. Adoption of written OA is advisable.
   a. To vary the statutory "default" rules: e.g., management, voting, profit sharing and distributions.
   b. Since taxable under I.R.C. Subchapter K, compliance with Section 704(b) regulations is important. E.g. maintenance of capital accounts, minimum gain chargeback, and qualified income offset.
   c. Freed of one class of stock limitations applicable to S corporation, members have great flexibility in provisions for allocations and distributions.
   d. Address continuity of business of LLC where unanimous consent to avoid dissolution cannot be obtained.
   e. Unless contained in a written OA, certain information must nevertheless be set out in writing. § 13.1-1028A.5.

5. Statutory rules that may not be changed by agreement.
   a. Requirement for unanimous consent for assignee of an interest to become a member. § 13.1-1040A.
   b. Requirement for unanimous consent to avoid dissolution on termination of membership. § 13.1-1046.3.

I. Adoption and Amendment.
   1. The OA must initially be agreed to by all members. § 13.1-1023B1.
   2. If the OA does not provide a method for its amendment, then all members must agree to amendment. § 13.1-1023B2.

J. Enforcement of OA.
   1. A court may enforce an OA by injunction or such other relief as it in its discretion determines to be fair and appropriate in the circumstances. § 13.1-1023C1.
   2. Under the circumstances described in § 13.1-1047, as an alternative form of relief, the Court may order dissolution. § 13.1-1023C2.
III. RELATIONSHIP OF LLC AND ITS MEMBERS TO THIRD PERSONS

A. Limited Liability.

1. Except as otherwise provided in the Virginia Code or as expressly provided in the Articles, no member, manager or other agent of an LLC will have any personal obligation for any liabilities of an LLC, whether arising in contract, tort or otherwise, solely by reason of being a member, manager or agent of the LLC. § 13.1-1019.

2. The "soley by reason of" phrase is to make clear that while members do not have the vicarious liability of partners, they are responsible for their own acts and for obligations undertaken by agreement, such as the guaranty by a member of a loan to an LLC.

3. The "except as otherwise provided by this Code" phrase was added in response to a concern expressed by the Office of the Attorney General that the section might be deemed to override sections imposing liability on "responsible persons" for certain unpaid taxes.

4. Other exceptions:
   a. Piercing the entity veil doctrine as in the corporate context may be applicable.
   b. Liability for unpaid contributions. § 13.1-1027B.

B. Parties to Actions.

A member is not a proper party to a proceeding by or against an LLC, except:

1. Where the object is to enforce the member's right against or liability to the LLC; or

2. As provided in Article 8 dealing with derivative actions. § 13.1-1020.

C. LLC Property.

Any estate or interest in property may be acquired in the name of an LLC, and title to any estate or interest so acquired vests in the LLC. § 13.1-1021.
IV. RELATIONSHIP OF MEMBERS TO EACH OTHER.

A. Management.

Unless the Articles or OA provide for management by managers, management is vested in the members. § 13.1-1022A.

B. Authority to Bind LLC.

Unlike LLC acts of other states, Act is silent on authority of a member or manager to incur a liability on behalf of LLC. Act does not confer authority upon members or managers authority to bind LLC merely by virtue of being member or manager. General agency principles should apply.

C. Voting.

1. Unless otherwise provided in the Articles or OA, members vote in proportion to their contributions to the LLC, as adjusted from time to time to reflect additional contributions or withdrawals. § 13.1-1022A.

   NOTE: May have unintended result where capital accounts have been adjusted to reflect a revaluation of partnership property under Treas. Reg. § 1.704(b)(2)(iv)(f).

   2. By comparison, UPA Virginia Code § 50-18(h) provides for voting per capita unless the parties have otherwise agreed.

D. Decision Making.

The Act does not specify the vote required for actions by members or managers.

Since Act does require unanimous consent to adopt the OA, presumably unanimous consent is the "default" rule.

E. Management by Manager.

1. The Articles or OA may apportion responsibility for management among one or more managers. § 13.1-1024A.

2. The managers must be natural persons at least 18 years old, but they need not be Virginia residents or members of the LLC unless the Articles or OA so require. § 13.1-1024B.

3. The Articles or OA may prescribe other qualifications for managers. § 13.1-1024B.
4. The number of managers is to be fixed by or in the manner provided in the Articles or OA, and may be increased or decreased by amendment. § 13.1-1024C.

5. Managers are to be elected by the members. § 13.1-1024D. Unlike the Wyoming Act, there is no requirement for annual election in the manner of corporate officers.

6. Unless otherwise provided in the Articles or OA, any vacancy in the office of manager is to be filled by a majority vote of the members. § 13.1-1024E.

7. Managers may be removed by a majority vote of members, unless the Articles or OA otherwise provide. § 13.1-1024F.

F. General Standards of Conduct for a Manager.

1. A manager is to discharge his duties as a manager in accordance with his good faith business judgment of the best interests of the LLC.

NOTE: Derived from the Stock Act, which omits duty of ordinary care in the MBCA.

2. Unless he has knowledge or information making reliance unwarranted, he may rely on information, opinions, reports or statements, including financial statements or financial data, if prepared or presented by:

a. Managers or employees he believes competent.

b. Professional advisors;

c. A committee of managers of which he is not a member.

NOTE: Permits good faith reliance - no reasonableness standard as in the MBCA.

3. A person alleging a violation of the standards of conduct has the burden of proving the violation.

(Source § 13.1-690. The counterpart of § 13.1-690C was deleted in the House.)

G. Limitation of Liability of Members and Managers.

1. In a proceeding by or on behalf of an LLC or its members, the damages assessed against a manager or member arising out of a single transaction, occurrence, or course of conduct cannot exceed the lesser of:
a. The monetary amount, including the elimination of liability, specified in the Articles or OA as a limitation on or elimination of the liability of the manager or member; or

b. The greater of (i) $100,000 or (ii) the amount of cash compensation received by the manager or member from the LLC during the preceding 12 months.

2. The foregoing limitation of liability does not apply if the manager or member engaged in willful misconduct or a knowing violation of a criminal law. § 13.1-1025B.

3. No limitation or elimination of liability may be modified retroactively.

§ 13.1-1025C.
(Source § 13.1-692.1)

While the section does not contain "unless otherwise provided in the OA," there is no reason why a beneficiary of the limitation may not waive it in whole or in part. For example, in partnership agreements, general partners frequently agree to indemnify against loss due to their gross negligence and even certain cases of negligence.

H. Business Transactions of Members and Managers with LLC.

1. Except as provided in the Articles or OA, any member or manager may lend money to and transact other business with an LLC and, subject to other applicable law, have the same rights and obligations with respect thereto as a person who is not a member.

§ 13.1-1026.
(Source § 50-73.10).

2. Presumably, as in the case of RULPA §107, from which source the provision is derived, transactions between a member and the LLC remain subject to the general fraudulent conveyance statute, and other doctrines developed under bankruptcy and insolvency laws. See Comment to RULPA §107. See, Retzke v. Larson, 803 P.2d 439, (Ariz. Ct. Apps. 1990). Applying analogous provisions of Arizona RULPA, held that "other applicable law" included the RULPA analogue of § 13.1-1035 and the Arizona Uniform Fraudulent Conveyance Act.

I. Information and Records Required to be Maintained.

1. The LLC must keep at its principal office the following:
a. Current list of full name and last known business address of each member in alphabetical order;

b. Copy of Articles and Certificate of Organization and all amendments thereto;

c. Copies of federal, state and local income tax returns and reports for the three most recent years;

d. Copies of any then effective written OA and any financial statements of the LLC for the three most recent years; and

e. Unless contained in a written OA, a writing setting out:

   (1) Amount of cash and description and statement of agreed value of all the property or services contributed by each member and which each member has agreed to contribute;

   (2) Times at which or events on happening of which additional contributions agreed to be made by each member are to be made;

   (3) Any right of member to receive, or the LLC to make, distributions to a member which include a return of all or any part of the member’s contributions; and

   (4) Any events upon the happening of which the LLC is to be dissolved and its affairs wound up.

§ 13.1-1028A. (Source § 50-73.8).

2. Each member has the right, upon reasonable request and subject to reasonable standards as set forth in OA to:

a. Inspect and copy any records required to be maintained; and

b. Obtain from the managers, or if none, from any member or other person with access to such information, from time to time upon reasonable demand:

   (1) Information regarding the state of the business and financial condition of the LLC;

   (2) Copy of the federal state and local income tax return for each year; and
(3) Other information regarding the affairs of the LLC as is just and reasonable.

(Source § 50-73.26)

V. FINANCE

A. Contributions.

1. Contributions may be in cash, property or services rendered or a promissory note or other binding obligation to contribute cash or property or to perform services.

§ 13.1-1027A.
(Source § 50-73.32A2).

2. Except as otherwise provided in the Articles or OA, a member is obligated to contribute cash or property or perform services, even if he is unable to perform because of death, disability or other reason. If he does not contribute the property or services, the LLC has the option to require him to contribute cash equal to the value, as stated in the records required to be maintained, of the contribution that has not been made.

§ 13.1-1027B.
(Source § 50-73.33A2).

3. Unless otherwise provided in the Articles or OA, the obligation of a member to contribute or to return money or property wrongfully distributed may be compromised only by consent of all members. Notwithstanding the compromise, a creditor who extends credit or otherwise acts in reliance on the original obligation may enforce the original obligation.

§ 13.1-1027C.
(Source § 50-73.33B).

4. No promise by a member to contribute is enforceable unless set forth in writing, signed by the member.

§ 13.1-1027B.
(Source § 50-73.33B)

B. Sharing of Profits and Losses.

Profits and losses are allocated among the members and among classes of members in the manner provided in writing in the Articles or OA; or if not so provided, then on the basis of value, as stated in the records required to be maintained, of the contributions made by each member.
§ 13.1-1029.
(Source § 50-73.34, except that the concluding "to the extent they have been received by the partnership and have not been returned" was omitted.)

Compare with default rule for voting, which does require adjustment for distributions.

C. Sharing of Distributions.

Distributions of cash or other assets are to be allocated among the members and among classes of members in the manner provided in writing in the Articles or OA; or if not so provided, then on the basis of the value, as stated in the records required to be maintained, of the contribution made by each member.

§ 13.1-1030.
(Source § 50-73.35, with same omission as in the case of the profit and loss sharing provision.)

D. Interim Distributions.

Except as provided in Article 6 of the Act, a member is entitled to receive distributions before resignation from the LLC and before dissolution and winding up to the extent and at the times or upon the happening of events specified in the Articles or OA.

§ 13.1-1031.
(Source § 50-73.36).

E. Resignation of Member.

A member may resign at the time or upon the happening of events specified in writing in the Articles or OA; or if not so specified, or a definite time for dissolution and winding up of the LLC is not so specified, any member may resign upon not less than six months' prior written notice to each member.

§ 13.1-1032.
(Source § 50-73.38).

F. Distribution Upon Resignation.

Except as otherwise provided in Article 6, upon resignation, a resigning member is entitled to receive any distribution to which he is entitled in the Articles or OA, and, if not otherwise provided in the Articles or OA, he is entitled to receive, within a reasonable time after resignation, the fair value of his membership interest as of the date of resignation.
§ 13.1-1033.
(Source § 50-73.39, except that concluding phase "based upon his right to share in distributions" was omitted.

G. Distribution in Kind.

Except as provided in writing in the Articles or OA, a member, regardless of the nature of his contribution, has no right to demand and receive any distribution in any form other than cash; and he may not be compelled to accept a distribution in kind disproportionate to his membership interest.

§ 13.1-1034.
(Source § 50-73.40)

H. Restrictions on Distributions.

1. No distribution may be made if, after the distribution:

   a. The LLC would not be able to pay its debts as they become due; or

   b. The LLC's total assets would be less than the sum of its liabilities plus, unless the Articles or OA otherwise permit, the amount needed to satisfy preferential rights upon dissolution of members whose preferential rights are superior to the rights of members receiving the distribution.

§ 13.1-1035A.
(Source § 13.1-653C)

2. The LLC may base a determination that a distribution is not prohibited on:

   a. Financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances; or

   b. A fair valuation or other method that is reasonable in the circumstances.

§ 13.1-1035B.
(Source § 13.1-653D)

3. The effect of a distribution is measured as of:

   a. Date the distribution is authorized if payment is made within 120 days after date of authorization; or
b. The date payment is made if made more than 120 days after the date of authorization.

§ 13.1-1035C.
(Source § 13.1-653E)

4. The LLC's indebtedness to a member arising from the declaration of a distribution is on parity with its indebtedness to its general unsecured creditors, except to the extent subordinated by agreement.

§ 13.1-1035D.
(Source § 13.1-653F)

5. If a member has received a distribution in violation of the Articles or OA or in violation of § 13.1-1035, then he is liable to the LLC for six years thereafter for the amount of the wrongful distribution.

§ 13.1-1036.
(Source § 50-73.43B but that section refers only to return of contributions)

I. Right to Distribution.

When a member becomes entitled to a distribution, he has the status of, and is entitled to all remedies available to, a creditor with respect to the distribution.

§ 13.1-1027
(Source § 50-73.41)

VI. RIGHTS OF AND ASSIGNMENT BY MEMBERS.

A. Nature of Interest in LLC.

1. A membership interest in an LLC is personal property.

§ 13.1-1038.
(Source § 50-73.44)

2. Member has no direct ownership interest in LLC assets.

B. Assignment of Interest.

1. "Membership interest" is a member's share of the profits and losses of the LLC and the right to receive distributions; it does not include any right to participate in management. § 13.1-1002.
2. Unless otherwise provided in the Articles or OA, a membership interest is assignable in whole or in part.

3. An assignment of an interest does not of itself dissolve the LLC.

   NOTE: However, if assignor ceases to be a member, then the dissolution provisions will be implicated.

4. An assignment does not entitle the assignee to participate in the management and affairs of the LLC or to exercise any rights of a member. The assignment entitles the assignee to receive, to the extent assigned, only any distributions to which the assignor would be entitled.

5. Except as provided in the Articles or OA, a member ceases to be a member upon assignment of his entire membership interest.

§ 13.1-1039.
(Source § 50-73.45)

C. Right of Assignee to Become a Member.

1. An assignee of an interest in an LLC may become a member only if the other members unanimously consent. § 13.1-1040A.

2. An assignee who has become a member has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member under the Articles, the OA and the Act. An assignee who becomes a member also is liable for any obligations of his assignor to make and return contributions as provided in Articles 5 and 6 of the Act; except that an assignee who becomes a member is not obligated for liabilities of the assignor unknown to him at the time he became a member. § 13.1-1040B.

3. If an assignee becomes a member, the assignor is not released from his liability to make contributions under § 13.1-1027 and to return wrongful distributions under § 13.1-1036.

§ 13.1-1040C.
(Source § 50-73.47)

D. Rights of Creditor.

1. Member has no direct ownership interest in the assets of an LLC that may be reached by his creditors.
2. Member's creditor may reach his interest in the LLC. A judgment creditor of a member may apply to court to charge the interest of a member with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the interest.

(Source § 50-73.46)

3. Presumably principles that have evolved in partnership context will be applicable.

VII. DISSOLUTION.

A. Non-Judicial Dissolution.

An LLC is dissolved and its affairs are to be wound up upon the happening of the first to occur of the following events:

1. At the time or on the happening of the events specified in the Articles or OA;

2. Upon unanimous written consent of the members;

3. Upon the death, resignation, expulsion, bankruptcy, or dissolution of a member or occurrence of any other event that terminates the continued membership of a member in the LLC, unless the business of the LLC is continued by the unanimous consent of the remaining members;

NOTE: This provision is more restrictive than RULPA, which permits the partnership agreement to provide for the avoidance of dissolution where there is a remaining general partner.

NOTE: While unanimous consent is required to avoid dissolution, the members may agree, as in the case of a partnership, that the business of the LLC may be continued without winding up by less than unanimous vote.


§ 13.1-1046
(Source § 50-73.49)

B. Judicial Dissolution.

On application by or for a member, a circuit court may decree dissolution of LLC if it is not reasonably practicable to
carry on the business in conformity with the Articles and any OA.

§ 13.1-1047.
(Source $50-73.50)

C. Winding Up.

Unless otherwise provided in the Articles or OA, the members who have not wrongfully dissolved an LLC may wind up the LLC's affairs; but, on cause shown, the Circuit Court may wind up the LLC's affairs on application of any member, and his legal representative, or assignee.

(Source $50-73.51)

Since the Act contains no provision for withdrawal or dissolution in violation of the operating agreement, "wrongful dissolution" of an LLC must refer to wrongful conduct resulting in judicial dissolution.

D. Distribution of Assets Upon Dissolution.

Upon winding up of LLC, its assets are to be distributed as follows:

1. To creditors, including members who are creditors, to the extent permitted by law, in satisfaction of liabilities of the LLC other than for distributions to members under §§ 13.1-1031 or 13.1-1033;

2. Unless otherwise provided in the Articles or OA, to members and former members in satisfaction of liabilities for distributions under §§ 13.1-1031 or 13.1-1033; and

3. Unless otherwise provided in the Articles or OA, to members first for the return of their contributions and second with respect to their interest in the LLC, in the proportions in which the members share in distributions.

(Source $50-73.52)

E. Certificate of Cancellation.

1. Upon completion of winding up of the LLC, a certificate of cancellation is to be filed with the SCC.

§ 13.1-1050A
(Source $50-73.13)
2. Winding up is completed when all debts, liabilities, and obligations of the LLC have been paid and discharged or a reasonably adequate provision therefore has been made, and all of the remaining property and assets of the LLC have been distributed to the members.

3. Unless otherwise provided in the Act or in the certificate, a certificate of cancellation (or judicial decree of cancellation) is effective when accepted for filing by the SCC. § 13.1-1050B.

VIII. DERIVATIVE ACTIONS.

A. Right of Action.

§ 13.1-1042B.
(Source § 50-73.62)

B. Proper Plaintiff.

(Source § 50-73.63)

C. Pleading.

§ 13.1-1044.
(Source § 50-73.64)

D. Expenses.

(Source § 50-73.64)

IX. FOREIGN LIMITED LIABILITY COMPANIES.

A. Law Governing.

Subject to the Virginia Constitution, the laws of the jurisdiction under which a foreign LLC is formed govern its formation and internal affairs, and the liability of its members and managers.

§ 13.1-1051.
(Source § 50-73.53)

B. Registration.

Before transacting business in Virginia, a foreign LLC must register with the SCC. Filing an application on forms prescribed and furnished by the SCC.

§ 13.1-1052.
C. **Issuance of Registration.**

§ 13.1-1053. 
(Source § 50-73.55)

D. **Name.**

1. A foreign LLC must meet the name requirements for a domestic LLC. If it does not, it may add the requisite words or abbreviation to its name for use in Virginia.

2. If the real name of a foreign LLC is unavailable in Virginia, it may use a designated name that is available.

§ 13.1-1054. 
(Source § 50-73.55)

E. **Transaction of Business Without Registration.**

1. A foreign LLC transacting business in Virginia may not maintain any action, suit or proceeding in a Virginia court until it has registered. § 13.1-1057A.

2. The failure of a foreign LLC to register does not impair the validity of any contract or act of the foreign LLC or prevent it from defending any proceeding in a Virginia court. § 13.1-1057B.

3. If a foreign LLC transacts business in Virginia without the requisite certificate, each member, manager or employee of the LLC who does any such business knowing that a certificate is required and has not been obtained is liable for a penalty. § 13.1-1057C.

4. A foreign LLC by transacting business in Virginia without registration, appoints the Clerk of the SCC as its agent for service of process with respect to causes of action arising out of the transaction of business in Virginia. § 13.1-1057D 
(Source § 50-73.59).

F. **Activities that do not Constitute Transacting Business.**

1. Specified activities, "among others" do not constitute transacting business.

2. Included is "owning, without more, real or personal property."
(Source § 13.1-757B9). Compare with § 50-73.61A9 which by 1987 amendment deleted "or real."

G. Law Governing Mergers of Foreign LLCs.

1. If a foreign LLC owning assets in Virginia is a party to a merger in which a foreign corporation, foreign limited partnership or foreign LLC is a successor, the transfer of those assets to the successor is governed by the laws of the place that governed the merger. § 13.1-1060.

2. Certificate to be issued by SCC upon request and may be admitted in local clerk's office to maintain continuity of title records. § 13.1-1067.

X. MERGER OF DOMESTIC LLC.

As with Virginia RULPA, there is no merger provision. The Partnership Committee of the Virginia Bar Association has drafted a provision to permit mergers of limited partnerships and stock corporations. However, further action was deferred pending a study by the Corporate Laws committee of the broader subject of entity mergers, which will include limited liability companies.

XI. TRANSACTING BUSINESS IN OTHER STATES.

A. Other States With LLC Acts.

In addition to Virginia, the following states have enacted limited liability company legislation: Wyoming, Florida, Colorado, Kansas, Utah, Texas and Nevada. Legislation is pending in a number of other states.

B. Portability.

It is unclear whether states that have not adopted LLC legislation will recognize the limited liability of members and managers or will treat an LLC as a partnership.


C. States Without LLC Acts That Recognize Foreign LLCs.

1. Indiana does not have an LLC Act, but it provides for registration of foreign LLCs. Ind. Code Ann. § 23-16-10.1-1 to 10.1-4.

2. The Maryland Attorney General has taken the position that a foreign LLC may register as a foreign corporation
in that state. Memorandum of Kaye Brooks Bushel, Maryland Assistant Attorney General, dated January 24, 1990.

XII. TAX ISSUES.

A. Classification.

1. IRS Position

The Service has "opened a project" to consider issuing a revenue ruling on the Virginia Act of the type issued for Wyoming.

2. Private letter rulings.

a. While the Service is studying its policy on a revenue ruling on LLC acts, it will accept and act upon requests for private letter rulings.

b. Rev. Proc. 89-12 specifies the conditions under which IRS will consider a ruling request on classification as a partnership.

At the November 1990 meeting the Service representatives acknowledged that Rev. Proc. 89-12 does not fit an LLC very well. Nevertheless, it appears that an attempt to comply with Rev. Proc. 89-12 will be required until further notice. The most recently issued LLC private ruling contained the following statement: "This ruling is subject to the requirements set forth in Rev. Proc. 89-12 . . . to the extent applicable. If the requirements of Rev. Proc. 89-12 fail to be met at any time, this ruling will have no force or effect." PLR 9119029.

IRS has stated that Section 4.07 of Rev. Proc. 89-12, dealing with the corporate characteristic of limited liability does not apply to LLCs. GCM 39798, n.3.

c. Rev. Proc. 91-13 amplifies Rev. Proc. 89-12 by providing a checklist of necessary documents and representations that must accompany a request for a private letter ruling on limited partnership classification. Although Rev. Proc. 89-12 states that "limited partnership" includes any other organization that limits the liability of any member for the organization's debts, the IRS has indicated that Rev. Proc. 91-13 is not applicable to a request on LLC classification.

3. Classification of Virginia LLC.

Based on principles of the classification regulations, as applied in Rev. Rul. 88-76, a Virginia LLC should be classified as a partnership for federal tax purposes.
a. IRC § 7701(a)(2) provides that "partnership" includes an unincorporated organization, through or by means of which any business' financial operation or venture is carried on, and which is not a trust, estate or corporation.

A Virginia LLC is an unincorporated organization. § 13.1-1002.

b. (1) The regulations set forth the following basic characteristics of a corporation:

(a) associates,

(b) an objective to carry on business and divide the gains therefrom,

(c) continuity of life,

(d) centralization of management,

(e) liability for corporate debts limited to corporate property, and

(f) free transferability of interests.

Treas. Reg. § 301.7701-2(a)(1).

(2) The first two characteristics are common to both partnerships and corporations and are to be disregarded. Treas. Reg. § 301.7701-2(a)(2).

(3) Of the remaining four characteristics, if an organization lacks two of them, it will be classified as a partnership. Treas. Reg. § 301.7701-2(a)(3).

(4) The Virginia Act was drafted so that, as is the case of a Wyoming LLC, a Virginia LLC will lack continuity of life and free transferability of interests.

(5) Continuity of life.

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. Treas. Reg. § 301-7701-2(a)(3). Rev. Rul. 88-76 concluded that given that a Wyoming LLC is dissolved upon the death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event that terminates the continued membership of a member unless the business of a Wyoming LLC is continued by the consent of all the remaining members, therefore, a Wyoming LLC lacks the corporate characteristic of continuity of
life. Similarly, since a Virginia LLC will be dissolved upon the same events unless the business of the LLC is continued by the unanimous consent of the remaining numbers, a Virginia LLC lacks continuity of life.

An assignment of an interest in a LLC does not of itself dissolve the LLC, but unless the members have otherwise agreed, a member ceases to be a member upon the assignment of his entire membership interest; and since that will "terminate the continued membership" of that member, the LLC will dissolve unless all the remaining members agree to continue. §§ 13.1-1039 and -1045.

(6) Transferability of interests

An organization has the corporate characteristic of free transferability of interests if each member or those owning substantially all the interests in the organization have the power, without the consent of other members, to substitute for themselves and confer all the attributes of the member's interest upon the substitute, a person who is not a member. The right to assign, without the consent of the other members, only the right to share in profits but not the right to participate in management, is not deemed to constitute free transferability. Treas. Reg. § 301.7701-2(a)(1).

Under the Wyoming Act, the assignee or transferee of a member does not become a substitute member and acquire all the attributes of a member's interest unless all the remaining members approve the assignment or transfer; and therefore the Wyoming LLC was deemed to lack the corporate characteristics of free transferability of interests. The Virginia LLC follows the Wyoming Act provisions on transferability of interests, and a Virginia LLC lacks free transferability of interests.

4. Virginia classification.

Under the Virginia conformity statute an LLC that is classified as a partnership for federal income tax purposes should be similarly treated for Virginia income tax purposes. § 58-301A.

B. Application of Partnership Tax Principles.

1. Organization

a. No gain or loss recognized to LLC or any member on the contribution of property to the LLC in exchange for an interest in the LLC. IRC § 721(a).

b. Basis of property contributed to LLC by a member equals the adjusted basis of such property to the contributing member. IRC § 723.

c. Basis of member's interest in LLC.

   (1) Member's basis in his LLC interest is increased by the amount of money contributed to the partnership and decreased by the amount of distributions. IRC §§ 705 and 722. For that purpose an increase in the member's share of liabilities of the LLC is treated as a contribution of money and a decrease in the member's share is treated as a distribution of money. IRC §§752(a) and (b).

   (2) A member's share of LLC liabilities is determined under the Section 752 regulations, with different rules applicable to recourse liabilities and nonrecourse liabilities.

   (3) Recourse liability. A member or related person bears the "economic risk of loss" for that liability. Prop. Reg. § 1.752-1(a)(1).

   (4) Nonrecourse liability. No member or related person bears the economic risk of loss for that liability. Prop. Reg. § 1.752-1(a)(2).

   (5) As in the case of the allocation rules, absent a member guarantee, all LLC debt should be treated as nonrecourse debt.

2. Conversion

a. Partnership to LLC.

Rev. Rul. 84-52, 1984-1 C.B. 157 applies. PLR 9119029 (conversion of limited partnership to LLC); PLR 9029019 (conversion of general partnership to LLC). Under Rev. Rul. 84-52 the conversion will be treated as an exchange under IRC § 721, so that no gain or loss will be recognized; and the LLC will be treated as a continuation of the predecessor partnership without termination under IRC § 708. Therefore, it should not be necessary to obtain a new tax identification number for the LLC or to remake various elections under subchapter K.
b. Corporation to LLC
Will be treated as a liquidation of the corporation.

3. Pass through rules
   a. LLC is not subject to tax. IRC § 701
   b. Members are liable for income tax in their individual capacities; each taking into account his distributive share of partnership items. IRC §§ 701 and 702(a).
   c. Loss allowed only to extent of adjusted basis of partner's interest in the partnership. IRC § 704(d).

4. Allocations.
   a. Under the IRC § 704(b) regulations, generally allocations of income, gain, loss, deduction, or credit (or item thereof) will be respected if the allocation has substantial economic effect taking into account all facts and circumstances, is in accordance with the partner's interest in the partnership, or is deemed to be in accordance with the partner's interest in the partnership pursuant to one of the special rules. Temp. Reg. § 1.704(b)(1)(i).
   
   b. An allocation of an item of loss, deduction, or section 705(a)(2)(B) expenditure attributable to nonrecourse liabilities ("nonrecourse deductions") of the partnership cannot have economic effect and must be allocated in accordance with the partners' interest in the partnership. Temp. Reg. § 1.704-1T(b)(4)(iv)(a)(1).
   
   c. Regulations provide a test under which certain allocations of nonrecourse deductions will be deemed to be in accordance with the partners' interest in the partnership. Temp. Reg. § 1.704-1T(b)(4)(iv)(d).
   
   d. Nonrecourse liability of a partnership is a liability of the partnership (or portion thereof) for which no partner bears the economic risk of loss. Temp. Reg. § 1.704-1T(b)(4)(iv)(k)(3).
   
   e. Absent a guarantee by a member of an LLC obligation, all debt of the LLC should be treated as nonrecourse debt because no member will bear the economic risk of loss with respect to the debt. That should include debt to which the general assets of the LLC are liable, such as trade debt, which is not ordinarily thought of as nonrecourse.
5. At Risk Rules

a. Generally, under IRC § 465 in the case of individuals and certain closely held C corporations a loss from activity subject to the section is allocable only to the extent of the aggregate amount with respect to which the taxpayer is at risk. IRC § 465(a)(1).

b. Except in the case of "qualified nonrecourse financing," a taxpayer is at risk with respect to amounts borrowed for use in an activity only to the extent that he is personally liable for repayment of such amounts, or has pledged property as security for the debt. IRC § 465(b)(2).

c. If a taxpayer guarantees repayment of an amount borrowed by another person for use in an activity, the guarantee does not increase the taxpayer's amount at risk. Even if the guarantor pays the debt, the amount at risk is not increased until the taxpayer has no remaining legal rights against the primary obligor. Prop. Reg. § 1.465-6(d).

d. Exception for qualified nonrecourse financing.

(1) A taxpayer is considered at risk with respect to his share of any qualified nonrecourse financing that is secured by real property used in the activity. IRC § 465(b)(6).

(2) Qualified nonrecourse financing is debt with respect to which no person is personally liable for repayment. IRC § 465(b)(6)(B)(iii).

(3) A partner's share of qualified nonrecourse financing is determined on the basis of that partner's share of partnership liabilities increased in connection with the financing within the meaning of Section 752. IRC § 465(b)(6)(C).

(4) If the Section 752 definition of nonrecourse applies, since recourse liability exists only to the extent that any partner or related person bears the economic risk of loss, then debt secured by LLC real property that is not restricted to the security would be qualified nonrecourse financing. However, the at-risk rule in addition to referring to the Section 752 test to determine a partner's share of qualified nonrecourse financing, describes it as financing with respect to which "no person" (not merely no member or related person) is personally liable for repayment. Jordan and Kloepfer, 69 Taxes at 208.

a. Section 469 disallows a deduction for the passive activity loss of an individual, trust, estate, personal service corporation, and closely held C corporation. IRC § 469(a)(1)(A).

b. Passive activity loss generally is the amount by which the passive activity deductions for the taxable year exceed the passive activity gross income for the year. IRC § 469(d)(1); Temp. Reg. § 1.469-2T(b)(1).

c. Passive activity means any rental activity and any activity which involves the conduct of any trade or business and in which the taxpayer does not materially participate. IRC § 469(c)(1).

d. Material participation.

Generally an individual is treated as materially participating in an activity for a taxable year if he meets one of seven tests: Temp. Reg. § 1.469-5T(a).

(1) The individual participates for more than 500 hours;

(2) The individual's participation constitutes substantially all of the participation of all individuals;

(3) The individual participates for more than 100 hours, and that participation is not less than that of any other individual;

(4) The activity is a significant participation activity and the individual's aggregate participation in all significant participation activities exceeds 500 hours;

(5) The individual materially participated for any 5 taxable years during the 10 immediately preceding taxable years;

(6) The activity is a personal service activity and the individual materially participated for any 3 preceding taxable years; or

(7) Based on all facts and circumstances, the individual participates on a regular, continuous and substantial basis.
e. Special restriction for limited partner.

(1) A limited partner is deemed to materially participate only by qualifying under tests (1), (5) or (6). Temp. Reg. § 1.469-5T(e)(2). By contrast an S corporation shareholder may satisfy any of the 7 tests.

(2) "Limited partner" is an individual whose liability for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount, such as capital contributions and contractual obligations to make additional capital contributions. Temp. Reg. § 1.469-5T(e)(3)(B).

(3) Under the Act a membership interest falls within the definition of a limited partnership interest.

Commentators have argued that manager-members should not be treated as limited partners for purposes of the material participation tests. Jordan and Kloepfer, 69 Taxes at 210.

A partnership interest is not treated as a limited partnership interest if the individual holder is a general partner at all times during the year. Temp. Reg. § 1.469-5T(e)(3)(ii). In the absence of a definition of "general partner" in the Section 469 regulations, they look to the definition under Rev. Proc. 89-12, which states that for organizations other than partnerships "general partner" will mean the members "with significant management authority relative to the other members." If that definition applied, then the interests of member-managers would not be treated as limited partners.

While the argument in favor of such a position by IRS is reasonable, it would seem to require an amendment of the regulations to reach that result.

7. Tax Matters Partner

a. Only a general partner may be designated by the partners as the "tax matters partner" for purposes of partnership audits. IRC § 6231(a)(7).

b. If there is no general partner, the IRS is authorized to designate the tax matters partner. IRC § 6231(a)(7).

c. The Code does not define a general partner. If the term is deemed to mean a partner with personal liability for the organization's liabilities, then in an LLC there will be no one whom the partners may designate.
Compare Rev. Proc. 89-12, which defines "general partner" to include a person with "significant management authority relative to the other members."

d. At the November 1990 meeting the IRS representatives indicated that the problem might require corrective legislation.

XIII. SECURITIES LAWS.

A. Security.


2. "Investment contract" exists when a person invests in a common enterprise and is led to expect profits solely from the efforts of others. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

B. Partnership Interest.

Generally a limited partner's interest is a "security" and that of a general partner is not.

Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F. 2d 236 (4th Cir. 1988) held that a general partnership interest was not a security where the partnership agreement allowed the general partners, when acting in concert with a group of other partners, to control major actions and to remove the managing general partner.

C. LLC Interest.

1. SEC has not yet addressed the issue.

2. SCC has informally indicated that it will apply the Howey analysis to determine whether an LLC interest is an entity for purposes of the Virginia Securities Act.

3. Applying the Rivanna Trawlers analysis to an LLC interest result in the interest's not being treated as a security where management is retained by the members or, in the case management authority is delegated to managers, where the members control major decisions and have the power to remove the managers.
XIV. BANKRUPTCY LAW.