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BEYOND TRANSFER TAXES: WHAT EVERY ESTATE PLANNER SHOULD KNOW ABOUT PARTNERSHIPS

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APPENDIX A

I. PARTNERSHIPS

A. Defined

For purposes of this outline, the use of the word “partnerships” is used in the broadest sense to include not only state law partnerships, but also other unincorporated entities taxed as partnerships under subchapter K of the Internal Revenue Code of 1986, as amended (the “Code”) (i.e., those unincorporated entities that have not elected to be taxed as an association under the “Check-the-Box” regulations).¹ Such entities include:

1. General Partnerships (GPs)
2. Limited Partnerships (LPs)
3. Limited Liability Partnerships (LLPs)
4. Limited Liability Limited Partnerships (LLLPs)
5. Limited Liability Companies (LLCs)
6. Series Limited Liability Companies (Series LLCs)
7. Low-Profit Limited Liability Companies (L3Cs)

B. Purpose of Outline

This outline focuses on selected non-transfer tax aspects of unincorporated organizations that estate planning attorneys should be familiar with if they advise clients on partnership, limited liability company and other unincorporated entity matters. While this outline touches upon several federal income tax aspects of partnerships, a general discussion of the federal income taxation of partnerships and limited liability companies is beyond the scope of this outline.

II. SELECTED CURRENT DEVELOPMENTS IN PARTNERSHIP TAXATION

A. Background

1. Investment vehicles are typically structured as limited partnerships, with investors becoming limited partners and the investment sponsor (typically also a LLC taxed as a partnership) becoming the general partner. The general partner provides management services to the limited partnership in exchange for an interest in future profits of the limited partnership, which is generally referred to as a “carried interest” or “profits interest.”

2. Under current law, gain from the sale of capital assets allocated to the general partner with respect to its carried interests is often taxed at long term capital gains rates (current individual federal rate of 15%). However, there are legislative proposals that generally

¹ Treas. Reg. § 301.7701-3. Unless otherwise indicated, all references to unincorporated entities assume such entities are not associations taxed as corporations.

would tax the carried interest income at ordinary income tax rates (current top federal rate of 35%).

B. Current Law

1. Receipt of Carried Interest

a. A general partner is not taxed on the receipt of a “profits interest” (i.e., a carried interest) in a partnership.²

(i) A “profits interest” in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership.

(ii) Tax-free receipt of a profits interest generally does not apply if the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, or in certain other limited circumstances.³

(iii) By contrast, a partnership “capital interest” received for services is generally includable in the partner’s income upon receipt or upon “vesting.”⁴ A partnership capital interest is generally an interest that would entitle the receiving partner to a share of the proceeds if the partnership’s assets were sold at fair value and the proceeds were distributed in liquidation.⁵

2. Character of Income

a. The character of gains, losses and income of partnerships (i.e., long term capital gains or ordinary income) flows through to the partners as if the recognition of income, gains or losses was realized directly by the partners.⁶

b. In a typical investment vehicle structure, the investment partnership will recognize capital gain income on the disposition of its investments and the general partner generally receives capital gain treatment on its allocable share of carried interest income.

² Rev. Proc. 93-27, 1993-2 C.B. 343; and Rev. Proc. 2001-43, 2001-2 C.B. 191. See also Prop. Reg. Sec. 1.83-3.

³ Rev. Proc. 93-27, 1993-2 C.B. 343; and Rev. Proc. 2001-43, 2001-2 C.B. 191. For a detailed discussion of “profits” interest,” see Section VIII.A.3., below.

⁴ Section 61 and 83; Treas. Reg. Sec. 1.721-1(b)(1).

⁵ Rev. Proc. 93-27, 1993-2 C.B. 343. For a detailed discussion of “capital interests,” see Section VIII.A.4., below.

⁶ Section 702 of the Internal Revenue Code of 1986, as amended (“Code”). All section references herein are to the Code, unless otherwise noted.

3. Self-Employment Tax

a. Employment taxes are generally imposed on the wages of an individual under the Federal Insurance Contributions Act (“FICA”). A similar tax is imposed on the net earnings from self-employment under the Self Employment Contributions Act (“SECA”).⁷

b. The SECA tax is broken up into two components: (1) the OASDA component, the rate of which is 12.40% of earnings up to a threshold amount (\$106,800 for 2009); and (2) the HI component, the rate of which is 2.90% and is not capped.⁸

c. Individuals who are general partners in a partnership are generally subject to self-employment tax on their distributive share of partnership income. However, certain types of income are excluded, such as gains from the sale or exchange of capital assets.

d. Accordingly, under current law, carried interest income attributable to capital gain is not subject to self-employment tax.

C. Legislative Proposals

1. To some, the general partner’s share of carry is attributable to his working and should be subject to ordinary income tax rates just like any other wage earner. To address the perceived inequities of the characterization issues described above, in 2007, several bills were introduced by House Democrats into the 110th Congress including among others HR 2834 that would have treated net income from certain profits interests and capital interest, including gain on the disposition of those interests, as ordinary income.

The Administration’s recent Budget Proposal released February 26, 2009, supports carried interest legislation. The scope of this legislation is unknown.

2. On April 2, 2009, House Ways and Means Committee member Sander M. Levin introduced a similar provision (the “Levin Bill”), which would tax allocations on a service-related partnership interest as ordinary income.⁹

3. A carried interest proposal was also reintroduced as a revenue raiser in President Obama’s fiscal year 2010 budget proposal. The proposal includes a provision to change the federal income taxation of “carried” interests. Similar to other recent bills and proposals addressing the same issue, under this proposal, an investment manager’s income derived from, and gain recognized from the sale of, its carried interest received in exchange for services provided (or to be provided) to the investment vehicle would be taxed as ordinary income for the performance of services, regardless of the character of the income at the partnership level. Individuals deriving income from a carried interest would also be required to pay self-employment taxes. While this and other bills have been primarily directed at hedge

⁷ Chapter 21 of the Code and Section 1401.

⁸ Sections 3101 and 3111.

⁹ H.R. 1935, 111th Cong. (2009).

fund and private equity fund managers, the legislative proposals are much broader in their actual impact.

D. The Levin Bill

1. Recharacterization of Income and Loss

a. Under the Levin Bill, any net income allocation with respect to an investment services partnership interest (“ISPI”) would be treated as ordinary income.¹⁰

(i) The term ISPI means any interest in a partnership which is held by any person if such person provides (directly or indirectly) a substantial quantity of such services as: (a) advising as to the merits of investing in, purchasing, or selling any specified asset, (b) managing, acquiring, or disposing of any specified asset, (c) arranging financing with respect to acquiring specified assets, or (d) any activity in support of any service described in (a) through (c).¹¹ The Levin Bill looks to reasonably anticipate services to be provided (directly or indirectly) by the service partner (or any other person related to such partner) on the date of the acquisition of the ISPI.

(ii) “Specified asset” generally means securities, real estate, commodities or options/derivative contracts thereto.

b. Net loss with respect to the ISPI is also treated as ordinary loss, but only to the extent of the prior net income from such interest. Disallowed net loss may be carried forward to future taxable years without limitation.¹²

c. Income from an ISPI that is recharacterized as ordinary income is also subject to self-employment tax.

2. Timing of Taxation

a. Even though the Levin Bill recharacterizes gain from carried interests as ordinary income, there is no special provision to change the timing of the income to the general partner. Therefore, taxation on a carried interest is still deferred to the point when the general partner realizes gain from the carried interest, not when the interest is granted.

3. Invested Capital

a. The recharacterization rules above do not apply to allocations of income, gain, loss or deductions to any portion of an ISPI which is a “qualified capital interest.”¹³

¹⁰ Levin Bill Section 710(a)(1). Net income means the excess of (i) income/gain over (ii) deduction/loss with respect to the ISPI. Levin Bill § 710(a)(3). Net loss means the excess of (ii) over (i). See id.

¹¹ Levin Bill Section 710(c).

¹² Levin Bill Section 710(a)(2).

¹³ Levin Bill Section 710(c)(2).

(i) Qualified capital interest generally means so much of a partner's interest in the capital of the partnership as is attributable to (a) the fair market value of any money or other property contributed to the partnership in exchange for the interest, (b) any amounts previously included in gross income with respect to the transfer of the interest, and (c) any items of income/gain taken into account with respect to the interest over any items of deduction/loss taken into account.

(ii) The invested capital exception only applies to a holder of an ISPI if (a) allocations of items are made by the partnership to such qualified capital interest in the same manner as allocations are made to other qualified capital interests held by unrelated partners who do not perform services, and (b) the allocations made to the other interests are significant compared to the allocations made to the qualified capital interest.

(iii) Upon a disposition of an ISPI, gain that is attributable to the qualified capital interest portion of the general partner's ISPI will not be subject to recharacterization.

b. An interest is not treated as acquired with invested capital if it is attributable to a loan made or guaranteed by any other partner or partnership.

c. Any loan or advance to the partnership made or guaranteed, directly or indirectly, by a partner not providing services to the partnership (or any person related to such partner) is taken into account as invested capital of the partner.

4. Disposition of Carried Interest

a. Any gain on the disposition of an ISPI is treated as ordinary income.¹⁴

b. Gain is recognized notwithstanding other provisions of the Code (e.g., certain non-recognition provisions of the Code, such as I.R.C. § 351 or § 721).

5. Disqualified Interests

a. The Levin Bill includes a provision designed to prevent the avoidance of recharacterization through the use of an entity other than a partnership.¹⁵

b. Any income or gain with respect to an interest in an entity will be treated as ordinary income if (a) the person performs (directly or indirectly) investment management services for any entity, (b) the person holds a "disqualified interest" in the entity, and (c) the value of the interest is substantially related to the amount of income or gain (whether or not realized) from the assets with respect to which the investment management services are performed.

¹⁴ Levin Bill Section 710(b).

¹⁵ Levin Bill Section 710(d).

c. Disqualified interest generally includes (a) any interest in an entity other than debt, (b) convertible or contingent debt, (c) any option or other right to acquire property described in (a) or (b), and (d) any derivative instrument entered into (directly or indirectly) with such entity or any investor in such entity.

(i) Disqualified interest does not include an interest in a partnership or a corporation that is taxable in the U.S. (i.e., a domestic corporation or a foreign corporation substantially all of the income of which is effectively connected with a U.S. trade or business).

(ii) S corporations are also generally excepted from disqualified interest definition.

6. Other Items

a. Compensation Deduction: Generally, when there is a compensation payment, a payor usually gets a deduction. However, the Levin Bill does not provide a deduction to the investment fund matching general partners' ordinary income recognition, so the effect is likely a reduction of the limited parnters' capital gain allocation, as under current law.

b. Impact on Non-Service Partner: Generally, there is no impact to the non-service partners as a result of the recharacterization of the income related to the carried interest.

c. Section 83: Section 83 generally provides that the fair market value of property received in connection with the performance of services is included in the gross income of the person who performed such services in the first taxable year in which the rights in such property are not subject to a substantial risk of forfeiture. However, Section 83(b) generally provides that a recipient can make an election to include "unvested" property in income prior to such vesting. The Levin Bill would add two new rules to Section 83 as follows:¹⁶

(i) the fair market value of a partnership interest issued for services would be treated as equal to the liquidation value of the interest, unless the Internal Revenue Services ("IRS") provides otherwise; and

(ii) the rule for a Section 83(b) election would be reversed, with the election deemed made unless the partner elects out of the inclusion rule.

d. Penalties: The proposed legislation would amend section 6662(b) to include understatements attributable to section 710(d). For this purpose, the penalty rate under section 6662 would be 40%, with no exception for understatements otherwise eligible for relief under the "reasonable cause" exception of section 6664.

¹⁶ Levin Bill Section 1.

III. JURISDICTION OF ORGANIZATION

A. Background

Notwithstanding that a practitioner and his or her client reside in a particular state, depending on the type of business activity of the partnership (in this case, likely a limited partnership), or limited liability company to be formed and the desired management structure, your client's interests may be better served by forming the entity in a foreign state rather than in the practitioner's home state.

B. Why Choice of Jurisdiction Will Be Respected

1. Most state limited partnership acts provide that the laws of the state in which a limited partnership is organized govern **relations** among the partners of the limited partnership and between the partners and the limited partnership, and the **liability** of partners as partners for an obligation of the limited partnership.¹⁷

2. Likewise, most, if not all state limited liability company statutes provide that the laws of the state in which a limited liability company is organized govern its organization and **internal affairs** and the **liability** of its members and managers.¹⁸

C. Questions to Ask when Considering Forming a Limited Liability Company (Some of these same questions (or variations thereof) apply when considering forming limited partnerships).

Because state limited liability company acts vary, practitioners might consider the following questions:

1. May a company have only one owner?¹⁹
2. May a company be formed for purposes other than to make a profit?²⁰ Are there any limitations on the type of business a LLC can undertake?²¹

¹⁷ See, for example, California Corporations Code § 15909.01. See also 6 Del. C. § 17-901(a)(1) which provides that the state in which a foreign limited partnership is organized govern its organization and internal affairs and the liability of its limited partners.

¹⁸ See, for example, 6 Del. C. § 18-901(a)(1). Note, California's LLC Act also adds that the laws of the state of formation govern the "authority of its managers and members." California Corporations Code § 17450(a). It is important to note that some states, like California, have adopted the "apparent authority" doctrine in its statute, whereas others, like Delaware, have not. Notwithstanding this distinction, some commentators consider the authority language in the California statute to be superfluous because the authority of a member or manager to bind the limited liability company should be governed by the internal affairs doctrine which is already recognized in the California statute, yet others argue that without the California "apparent authority" language, a third person in California may argue that a member of a Delaware LLC's actions are binding if such member had apparent authority even if such member did not have actual authority as required under Delaware law.

¹⁹ This is relevant if the practitioner wants to form a single member limited liability company and be treated either as a disregarded entity for federal income tax purposes and respected as an entity for state law purposes or "check-the-box" to be treated like a corporation for federal income tax purposes.

3. Whether owners have the power and right to withdraw from a company and receive a distribution of the fair value of the interests? Whether the owners have a right to interim distributions?
4. Who has the apparent authority to bind the company and the limits of that authority?²²
5. What are the fiduciary duties of owners and managers to a company and each other? Can they be eliminated or merely modified?²³
6. Under what circumstances will a court disregard the separate existence of a LLC in order to impose liability from the owner of the LLC? Are there formality requirements for maintaining a “corporate veil”?²⁴

²⁰ Some states provide that limited liability companies may be formed for any “lawful business” purpose. See § 201 of the New York Limited Liability Company Act. The use of LLCs for nonprofit activities in such states may be prohibited by the reference to a “business” purpose which arguably infers a “profit” activity. The LLC acts of California and Delaware provide that limited liability companies may carry on any lawful business purpose “whether or not for profit.” See 6 Del. C. § 18-106 and California Corporations Code § 17002.

²¹ For example, under the California Limited Liability Company Act, § 17375 provides that there is nothing in the Act to permit either a foreign or domestic LLC from rendering professional services. Accordingly, unless there is an affirmative statute to the contrary, no professional services may be conducted as a limited liability company. The Attorney General of the State of California opined that such prohibition only applies to services requiring a license under the California Business and Professions Code if the service rendered requires more than a nonprofessional occupational license (i.e., law, medicine, accounting, general contractor). See Appendix A for a copy of the opinion.

²² See Cal. C. C. § 17157. Managers (and not non-manager members) of a “manager-managed” LLC have the apparent authority to bind the LLC.

²³ See the discussion below at Paragraph “IV Fiduciary Duties.”

²⁴ Entity veil piercing is an equitable principle not set forth in corporate statutes and, as such, there is no definitive statement of the rule. Over the years, courts have articulated principal factors contributing to veil piercing, including the owner’s disregard of the separateness of the entity (e.g. comingling of assets), undercapitalization of activities, distribution of assets that are viewed as fraudulent, degree of overcontrol, and failure to follow corporate formalities. Since corporate law and creditors rights are generally matters of state law, the standards for piercing the corporate veil are not uniform from state to state. Most commentators assert that where the statute provides that the state of formation governs the liability of the members (as do almost all state LLC statutes), it is the law of the state of formation that determines the personal liability of members to third persons under a veil piercing theory or otherwise. See Bronstein v. Crowell, Weedon & Co., No. B191738, 2007 WL 969559 (Cal App. 2 Dist. April 3, 2007) where the plaintiff sought to pierce the veil of a Delaware LLC and hold a 30% owner liable under an alter ego doctrine. The court noted the application of the alter ego doctrine to LLCs under the California LLC statute and stated that the alter ego doctrine is also available to Delaware LLCs. The court stated that the liability of members of a foreign LLC is governed by the law of the state of formation under California law. The Court concluded that the plaintiffs failed to present evidence raising a triable issue of fact as to whether a 30% owner of the LLC was liable under the alter ego doctrine, finding that the owner’s alleged concealment of his ownership in the LLC was insignificant in as much as a 30% interest is insufficient to make a controlling decision in a Delaware LLC. Unfortunately, some courts have gotten it wrong and limited the state law to govern the “internal affairs” and not a member’s liability to third parties, notwithstanding the statute’s language. See Butler v. Adoption Media, LLC, 486 F. Supp 3d 1002 (N.D. Cal. 2007) where the court applied California law and not Arizona law to determine whether Arizona LLCs doing business in California were the alter egos of the individual members.

7. How are the rights to manage a company allocated among its owners and managers?
8. Do the owners have the right to sue a company and its other owners in their own right as well as derivatively on behalf of the company?²⁵
9. May general and limited partnerships be converted to limited liability companies and may limited liability companies merge with other limited liability companies and other business organizations?
10. What is the law governing foreign limited liability companies and are any or all of these and other rules simply default rules that may be modified by agreement or are they nonwaivable?²⁶
11. Do members have dissenters rights in the event of a sale of the company?²⁷

IV. FIDUCIARY DUTIES

A. General Rule

Duties of good faith and fair dealing and fiduciary duties generally exist in every form of business organization as the “default” rule (i.e., by statute unless otherwise modified by agreement if modification is permitted). A fiduciary duty is the duty of care (i.e., the duty to act in good faith with the care of a prudent person) and the duty of loyalty (i.e., refrain from dealing with the organization when having an interest adverse to the organization). In organizations with *centralized management*, like a corporation or a manager-managed LLC, fiduciary duties are owed from the board or manager and the organization’s officers to the organization’s equity holders. An organization with *decentralized management*, like a general partnership or a member-managed LLC, fiduciary duties are owed by the owners to one another and to the organization.

²⁵ Under Delaware law, the demand requirements of Chancery Court Rule 18.1 must be satisfied in any derivative pleading. Wood v. Baum, 953 A.2d 136 (Del. July 1, 2009) (Jacobs). Note, in a recent case interpreting LLC law of Virginia, because the Virginia LLC statute did not explicitly provide that managers of a LLC have a fiduciary duty to its members and the operating agreement did not provide for such a direct duty, the Circuit Court of Virginia held that a member had to bring a derivative action and not a direct action against the manager of a LLC for an alleged breach of fiduciary duty to the individual member. Remora Investments, LLC v. David L. Orr, Record No. 080313, Justice Lemons, 2/27/09.

²⁶ Some statutes require that the operating agreement be in writing. For example in Noble v. A & R Environmental Services, LLC, 164 P.3d 519 (Wash. App. 2007), the Court concluded that statutory default provisions regarding distribution of assets in dissolution applied in absence of written operating agreement regardless of subjective intent of members regarding ownership interests because Washington LLC statute defines operating agreement as written agreement). See also, Olson v. Halvorsen, 2008 WL 4661831 (Del. Ch. October 22, 2008) finding statute of frauds applicable to an alleged oral operating agreement provision. See Calif. Corp. Code § 17005(d) that requires the modification of fiduciary duties to be in writing.

²⁷ Members have dissenters rights under the California LLC Act - § 17600 et. seq. The Delaware LLC Act does not explicitly provide for dissenters rights, unless drafted into the limited liability company agreement. See 6 Del. C. § 18-210.

B. Statutory Provisions

1. **Historically.** Section 21 of the Uniform Partnership Act of 1914 provides that: “Every partner must account to the partnership for any benefit, and hold as trustees for it any profits derived by him without the consent of the other partner from any transaction connected with the formation, conduct or liquidation of the Partnership or firm any use by him of its property.”²⁸

In describing the duty a partner owes to another, courts have often relied upon Justice Cardozo’s definition of a partner as a fiduciary in the seminal case of Meinhard v. Salmon.²⁹

2. **Revised Uniform Partnership Act of 1994 (RUPA).** In an effort to curtail the unchecked (and, in many commentators’ view, unjustified) expansion of a partners’ duties to his or her partners by the courts under the UPA, RUPA adopted a new section, § 404, that was both comprehensive and exclusive in defining the duties that a partner owes to another partner. Section 404 begins by stating that the “**only** fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care” as defined in Section 404.³⁰ The comments to RUPA note that the term “fiduciary” is misleading when defining the duties of a partner because a partner may legitimately pursue his self-interest (as in a law partnership when deciding on profit sharing) and not solely the interest of the partnership and the other partners, as must a true trustee.

3. **California.**

a. *General Partnerships.* The fiduciary duty of a partner is set forth in § 16404, namely (i) the **duty of loyalty** which requires accounting for the partnership’s property and profit, refraining from dealing with the partnership if adverse to the partnership’s interest and refraining from competing with the partnership;³¹ and (ii) the **duty of care** to not act in a grossly negligent manner.³²

²⁸ Note, Section 21 of the Uniform Partnership Act of 1914 is entitled “Partner Accountable as a Fiduciary;” yet the word “fiduciary” does not appear in the section nor does it state that there is any “duty” or that there is a duty of “loyalty.”

²⁹ 164 N.E. 545 (NY 1928). Justice Cardozo stated that “joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty . . . A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”

³⁰ Note, California’s version of § 404 of RUPA, found in § 16404 of the California Corporations Code, does not include the word “only.” Hence, it could be inferred that there may be other fiduciary duties owed in addition to the duty of loyalty and the duty of care set forth in § 16404.

³¹ Calif. Corp. Code § 16404.

³² This is the same standard under RUPA and historically recognized by the Courts. See e.g. Rosenthal v. Rosenthal, 543 A. 2d 348, 352 (MC 1988).

b. Limited Partnerships.³³

(i) The general partner’s duty to the limited partnership and the other partners is the same as what a partner owes to a general partnership and its partners under the California Uniform Partnership Act of 1994.³⁴

(ii) Unlike prior California limited partnership acts, the California Uniform Limited Partnership Act of 2008 provides explicitly that **limited partners owe no fiduciary duty** to the limited partnership or to any other partner solely by reason of being a limited partner, but if it has duties, it must exercise its rights with the obligation of good faith and fair dealing.³⁵

c. Limited Liability Companies.

(i) Manager-Managed. The fiduciary duties a manager owes to the LLC and to its members are the same as those a partner owes to a partnership and to the partners of the partnership.³⁶

(ii) Member-Managed. The members’ fiduciary duties are the same as those of a manager of a manager-managed LLC.³⁷

³³ There have been three limited partnership acts passed in California:

- (a) Uniform Limited Partnership Act (§§ 15501-15534 of the California Corporations Code), which until January 1, 2010, applies only to limited partnerships formed before July 1, 1984 that did not elect to be governed by the California Revised Limited Partnership Act or the Uniform Limited Partnership Act of 2008;
- (b) California Revised Limited Partnership Act (§§ 15611-15724 of the California Corporations Code), which until January 1, 2010, applies to all limited partnerships formed on or after July 1, 1984 and before January 1, 2008, and all limited partnerships before July 1, 1984 that elect to be governed by the California Revised Limited Partnership Act; and
- (c) Uniform Limited Partnership Act of 2008 (§§ 15900-15912.07 of the California Corporations Code), which applies to limited partnerships formed on or after January 1, 2008, those earlier limited partnerships that opt in and, except as set forth in § 15912.06, all limited partnerships, even those formed under the ULPA and CRLPA, as of January 1, 2010.

³⁴ See Calif. Corp. Code § 15722 of the California Revised Limited Partnership Act and Calif. Corp. Code § 15904.08 of California’s Uniform Limited Partnership Act of 2008.

³⁵ § 15903.05 of Calif. Corp. Code.

³⁶ § 17153 Calif. Corp. Code. See also, Goldberg v. Stelmach, No. B199830, 2008 WL 4428650 (Cal. App. 2D Ct. 2, 2008) noting that LLC manager owed same fiduciary duties to LLC and members as a partner owes to a partnership and partners. Under California law, to be considered a “manager-managed” LLC, the Articles of Organization of the LLC must contain a statement that the affairs of the LLC shall be managed by one or more managers. The California Limited Liability Company Act does not impose specific fiduciary duties upon members of a manager-managed LLC, although the general consensus is that such members have limited rights like limited partners of a limited partnership and, hence, owe no fiduciary duties solely by reason of being a member.

³⁷ § 17150 Cal. Corp. Code.

4. Delaware.

a. *General Partnerships.* Delaware imposes the same fiduciary duty on general partners that is imposed on partners under the Revised Uniform Partnership Act.³⁸

b. *Limited Partnerships.* The Delaware Limited Partnership Act does not impose specific duties upon the general partner accordingly, the Delaware Uniform Partnership Law governs. Therefore, a general partner of a limited partnership owes the same fiduciary duty to the limited partnership and the partners that a general partner owes to a general partnership and its partners.³⁹

c. *Limited Liability Companies.* The Delaware Limited Liability Company Act does not impose specific fiduciary duties upon managers or members. Rather, the existence of fiduciary duties is assumed.⁴⁰

C. Contractual Modification of Fiduciary Duties.

For practitioners who represent general partners of limited partnerships and managers of limited liability companies and who desire to reduce or eliminate their fiduciary duties, it is essential that the entity be formed in a jurisdiction that permits and respects such modifications. Those states that explicitly or implicitly impose specific fiduciary duties upon partners, managers or members, generally permit such duties to be modified by contract of the parties.

1. General Partnerships.

a. Under California's Uniform Partnership Act of 1994, the partnership agreement may not: "unreasonably reduce the duty of care;" "eliminate the obligation of good faith and fair dealing"(but may prescribe standards by which performance of the obligation is to be measured); or "eliminate the duty of loyalty," "but if not manifestly unreasonable," the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty.⁴¹

b. Under Delaware's Revised Uniform Partnership Act, the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing. Unlike the Delaware Revised Uniform Limited Partnership Act and the Delaware Limited Liability Company Act, there is no provision in the statute that explicitly provides that fiduciary duties may be eliminated, but the Delaware Revised Uniform Partnership Act does provide that liability for breach of fiduciary duty may be eliminated. A partnership agreement governed by Delaware law may provide for the elimination of liabilities for breach of fiduciary duties; provided that partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith

³⁸ 6 Del. C. § 15-404. See Revised Uniform Partnership Act of 1994, § 404.

³⁹ 6 Del. C. § 17-1105.

⁴⁰ See Shamrock Holdings v. Arenson, 456 F. Supp. 2d 59 (D. Del. 2006).

⁴¹ § 16103(b)(3), (4) and (5) of Calif. Corp. Code.

and fair dealing.⁴² A partner is not liable to a partnership or another partner for breach of fiduciary duty for the partner's good faith reliance on the provisions of the partnership agreement.⁴³

2. Limited Partnerships.

a. A limited partnership agreement governed by the California Revised Limited Partnership Act may modify the fiduciary duties of a general partner similar to the modifications that a general partnership agreement may make to the fiduciary duties of a general partner of a partnership governed by California's Uniform Partnership Act of 1994.⁴⁴

b. Under the Delaware Revised Uniform Limited Partnership Act, the policy of the Act is to give maximum effect to the principle of freedom of contract and to the unenforceability of partnership agreements.⁴⁵ To the extent a partner has duties (including fiduciary) to a limited partnership or to another partner, such duties may be expanded or restricted or eliminated by the limited partnership agreement provided that the implied covenant of good faith and fair dealing may not be eliminated.⁴⁶

3. Limited Liability Companies.

a. Under California's Limited Liability Company Act, the fiduciary duties of a manager to the LLC and to the member of the limited liability company⁴⁷ may only be modified in a *written* operating agreement with the informed consent of the members.⁴⁸

b. Under Delaware's Limited Liability Company Act, the principles of freedom of contract and the right to eliminate fiduciary duties is the same as under the Delaware Revised Uniform Limited Partnership Act.⁴⁹ It is explicit in the Delaware Limited Liability Company Act that fiduciary duties may be modified by contract of the parties.

(i) Case law has developed in Delaware, and many other jurisdictions, to the effect that persons in control of business entities other than corporations may not use the position of control for personal benefit to the detriment of the beneficial owners of the enterprise. Courts addressing the fiduciary duties of control persons of alternative entities

⁴² 6 Del. C. § 15-103(b)(3) and (f).

⁴³ 6 Del. C. § 15-103(e).

⁴⁴ § 15711 and § 16103 of the Calif. Corp. Code. There is no provision in the California Uniform Limited Partnership Act (pre-July 1984 limited partnerships) that explicitly address modification of a general partner's fiduciary duties.

⁴⁵ 6 Del. C. § 17-1101(c).

⁴⁶ 6 Del. C. § 17-1101(d).

⁴⁷ See § 17153 of the Calif. Corp. Code and § 16404 for a manager's fiduciary duties. This also applies to members in a California LLC that is member-managed within the meaning of the California Limited Liability Company Act.

⁴⁸ § 17005(d). Note, unlike Delaware, fiduciary duties cannot be eliminated. Further, although the manager owes the same fiduciary duty to its members as a partner to its partners, the right of modification of the fiduciary duty is different. Under the LLC Act, the modification must be in writing and must be with the informed consent of the members.

⁴⁹ 6 Del. C. § 18-1101(C) and (D).

have analogized such duties to corporate fiduciary duties. One recent case stated that fiduciary duties are typically found to exist where someone exercises dominion or control over someone else's assets or property "such that the controlling person should be prohibited from dealing with those assets in a manner that unfairly profits himself. Weil v. Morgan Stanley DW Inc., 2005 WL 1774113 (del. Ch.). Also, In re OODC, LLC, 321 B.R. 128 (Bkrtcy. D. Del. 2005), the Court held that an individual breached fiduciary duties to a LLC even though the individual was not an officer, director or majority owner of the LLC because he had actual control over the LLC. In this case, the Court determined that the largest preferred equity holder in the debtor LLC's parent had exercised dominion and control over the debtor LLC of formulating and consummating a leveraged buyout that rendered the LLC insolvent.

(ii) The business judgment rule should be available to protect control persons of limited liability companies against challenges to their decision-making based upon comparable factors as are relevant to a review of decisions of corporate directors. These factors are: (i) disinterestedness (the absence of self-dealing) and (ii) the independence and good faith of those persons exercising control and making decisions.

(iii) The principle of freedom of contract, as mandated by the Delaware Act,⁵⁰ was highlighted and endorsed by Delaware's Chief Justice Myron T. Steele when he said, "Courts should recognize the parties' freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties, or the judicial scrutiny associated with them, where the parties have not contracted for those governance mechanisms in the documents forming their business entity...[C]ontractual analysis, will demonstrate that the latter [contractual analysis vs. common law fiduciary duty] is more efficient, more consistent with the parties' business judgment about how to resolve manager/investor governance tension, and fulfills any rational view of appropriate public policy... Barring any evidence to the contrary, courts should restrain themselves from reaching any conclusion other than those that the parties, who are perceived to have understood the terms of the written agreement and bargained for and negotiated the relationship created by the contract in exchange for consideration. Courts should assume, absent clear and convincing evidence to the contrary, that implicit in the process were considerations of fee arrangements and investment entry costs."⁵¹

V. INDEMNIFICATION

A. Generally. It is not uncommon for general partners who organize limited partnerships and managers who form limited liability companies to include in the partnership agreement and the limited liability company or operating agreement, exculpatory and indemnification provisions that generally provide that the general partners, managers and their shareholders, directors, employees and agents are not liable for damages due to their good faith mistakes and that they will be indemnified and held harmless for damages arising from such mistakes provided their conduct did not constitute fraud, and willful misconduct, or gross negligence.⁵² Even in, or perhaps especially in, family partnerships and LLCs, special

⁵⁰ 6 Del. C. § 18-1101(b).

⁵¹ Steele, Judicial Scrutiny of Fiduciary Duties, 32 Del. J. Corp. L. 1. 4-6 (2007).

⁵² The following is an example of exculpatory and indemnification language from a limited partnership agreement:

“ _____ ” **Exculpation.** Neither the tax matters partner, the General Partner, the Management Company, or the members of the LP Advisory Committee (and the Limited Partners represented by such members with respect to each such member’s activities as an LP Advisory Committee member) and the Advisory Board, nor their respective managers, members, partners, principals, officers, employees, Affiliates, consultants, advisers or agents, shall be liable, responsible or accountable in damages or otherwise to the Limited Partners or the Partnership for honest mistakes of judgment, or for any action or inaction, taken in good faith, or for losses due to such mistakes, action, or inaction, or to the negligence, dishonesty, or bad faith, of any employee, broker, or other agent of the Partnership, *provided that* such employee, broker, or agent was selected, engaged, and retained with reasonable care. The General Partner and such persons may consult with counsel and accountants in respect of Partnership affairs and be fully protected and justified in any action or inaction that is taken in accordance with the advice or opinion of such counsel or accountants, *provided that* they shall have been selected with reasonable care. Notwithstanding any of the foregoing to the contrary, the provisions of this paragraph and paragraph ____ shall not be construed so as to relieve (or attempt to relieve) any person of any liability by reason of (a) in the case of any person other than an LP Advisory Committee member or the Limited Partner represented by such LP Advisory Committee member, fraud, willful misconduct, gross negligence or a violation of this Agreement or of applicable law which has a material adverse effect on the Partnership, and (b) in the case of an LP Advisory Committee member or the Limited Partner represented by such LP Advisory Committee member, bad faith or, in any case, to the extent (but only to the extent) that such liability may not be waived, modified, or limited under applicable law, but shall be construed so as to effectuate the provisions of such paragraphs to the fullest extent permitted by law. This paragraph ____ is intended to apply solely for the benefit of the Limited Partners, and in no way shall be construed or interpreted as inuring to the benefit of any other person or entity, including, without limitation, creditors of the Partnership, of the General Partner or of the members of the General Partner or other third parties.

“ _____ ” **Indemnification.** The Partnership agrees to indemnify, out of the assets of the Partnership only (but including amounts that the Partners may be required to contribute pursuant to paragraph ____), the General Partner, the Management Company, the members of the LP Advisory Committee (and the Limited Partners represented by such members with respect to each such member’s activities as an LP Advisory Committee member) and the Advisory Board, and the tax matters partner, and their respective managers, members, partners, principals, officers, employees, Affiliates, consultants, advisers or agents (the “*Indemnified Parties*”), to the fullest extent permitted by law and to save and hold them harmless from and in respect of all (a) reasonable fees, costs, and expenses, including legal fees, paid in connection with or resulting from any claim, action, or demand against the Indemnified Parties that arises directly or indirectly out of or in any way relates to the Partnership, its properties, business, or affairs and (b) such claims, actions, and demands, and any losses or damages resulting from such claims, actions, and demands, including amounts paid in settlement or compromise of any such claim, action or demand; *provided, however*, that this indemnity shall not extend to any conduct which constitutes (a) in the case of any person other than an LP Advisory Committee member or the Limited Partner represented by such LP Advisory Committee member, fraud, willful misconduct, gross negligence or a violation of this Agreement or of applicable law which has a material adverse effect on the Partnership and, (b) in the case of an LP Advisory Committee member or the Limited Partner represented by such LP Advisory Committee member, bad faith; *provided, further*, this indemnity shall not extend to any action or claim brought by any Indemnified Party against one or more other Indemnified Parties; *provided, further*, this indemnity shall not extend to any action, claim or demand brought against any Indemnified Party with respect to the Indemnified Party’s service as a director, officer or employee of a portfolio company of the Partnership to the extent such action, claim or demand is brought more than six (6) months after the Partnership has disposed of substantially all of its interest in Securities of the portfolio company and such action, claim or demand relates to any act or failure to act by the Indemnified Party which occurred after the Partnership’s disposal of such Securities. Expenses incurred by any Indemnified Party in defending a claim or proceeding covered by this paragraph shall be paid by the Partnership in

consideration should be given to exculpatory and indemnification provisions. Practitioners should be careful to draft exculpatory provisions that have similar standards for indemnity. It would be odd, for example, to say that a person will be indemnified for certain conduct, but that same person not also be exculpated for that conduct. For example, in a recent Delaware case, Stockman v. Heartland Industrial Partners L.P., No. 4227-VCS (July 14, 2009), Vice Chancellor Strine tried to reconcile differences in the exculpation provisions and indemnification provisions of a Partnership Agreement and noted that “It would be strange for the Partnership Agreement’s drafters to have identified to have different standards of conduct for indemnification and liability insulation given the identical nature of the language used.”

B. Statutory Authority.

1. California Law. California’s partnership statutes, unlike Delaware’s, does not affirmatively provide that partners can contractually determine the extent of indemnification under a partnership agreement, although courts have recognized such rights because the partnership statutes do not limit the scope of indemnification and permit modification of the default rule on indemnity. In fact, the “default” rule under the California Uniform Partnership Act of 1994 and the California Uniform Limited Partnership Act of 2008 is that the partnership is to indemnify the general partner for liabilities incurred by the general partner in the ordinary course of the activities of the partnership.⁵³ Under California’s Limited Liability Company Act, the statute explicitly authorizes a “written” operating agreement to indemnify any manager, member, officer or employee for activities carried out in that capacity.⁵⁴

2. Delaware Law. Delaware’s Revised Uniform Partnership Act,⁵⁵ Revised Uniform Limited Partnership Act,⁵⁶ and Limited Liability Company Act⁵⁷ allow for contracting parties to determine the extent of indemnification in their agreements. In fact, as noted by the court in Stockman, *supra*, limited partnerships and LLCs are given wider freedom to craft their own indemnification scheme than is available to corporations under § 145 of the Delaware General Corporate Law, which creates mandatory indemnification rights for corporate indemnities in some circumstances and also bars indemnification in others.

C. Advancement of Expenses.

advance of the final disposition of such claim or proceeding, provided the Indemnified Party undertakes to repay such amount if it is ultimately determined that such Indemnified Party was not entitled to be indemnified; *provided, however*, no such advance shall be made with respect to any claim or proceeding brought by a Majority in Interest of the Limited Partners. The provisions of this paragraph ___ shall remain in effect as to each Indemnified Party whether or not such person continues to serve in the capacity that entitled such person to be indemnified.

⁵³ See Calif. Corp. Code §§ 16401(c); 16103 and §§ 15904.06(c) and 15901.10.

⁵⁴ § 7155 Calif. Corp. Code. See also Calif. Corp. Code § 17003(l) which states that a LLC has the power to indemnify and hold harmless any person.

⁵⁵ 6 Del. C. § 15-110.

⁵⁶ 6 Del. C. § 17-108. It provides, “Subject to such standards and restrictions, if any, as are set forth in its partnership agreement, a limited partnership may, and shall have the power to, indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever.”

⁵⁷ 6 Del. C. § 18-108. This section is verbatim § 17-108 but refers to the limited liability company agreement rather than a partnership agreement.

Generally, the right to be advanced legal fees in connection with a matter that may ultimately result in the right to indemnity from a partnership or LLC cannot be presumed by a provision alone of indemnification. “Advancement” and “Indemnification” are two distinct types of legal rights and absent defined advancement rights in a partnership or LLC agreement, there is no implied right of advancement.⁵⁸ Accordingly, if the organizer of a LLC or partnership desire legal fees and expenses incurred by an indemnitee be advanced prior to the final disposition of a matter, then the agreement should so state.⁵⁹

1. The public policy of Delaware is to allow advancement of expenses if the partnership or LLC agreement so provides, even in cases in which the plaintiff is a limited partner and the claims are for breach of fiduciary duty.⁶⁰

2. To understand the importance of drafting advancement and indemnification clauses and the consequences of ambiguous drafting, see Stockman, *supra*. In that case, the Delaware Court of Chancery ruled in favor of advancement and indemnity of the partnership’s investment professionals.

D. Allocation of Indemnification Obligations Among Multiple Indemnitors.

1. In Levy v. HLI Operating Company, Inc., C.A. No. 1395-VCL (Del. Ch. May 16, 2007), the Delaware Chancery Court addressed the relative responsibility for indemnification obligations when a private equity fund partner is entitled to indemnification from the fund’s portfolio company on whose board the partner served and from his investment fund. The Court concluded that when there is more than one indemnitor, the liability is shared equally absent an agreement to the contrary. The broader implication of the case is that when there are multiple indemnitors, such as from a LLC that is a general partner of a limited partnership and the limited partnership itself, the order of liability sharing needs to be spelled out or may lead to unintended consequences. For example, if the primary indemnitor is the entity that holds assets, like a limited partnership, and not the general partner of the limited partnership, then the limited partnership agreement should so state.⁶¹

⁵⁸ See Senior Tour Players 207 Mgmt. Co. LLC v. Golftown 207 Holding Co. LLC, 853A 2d 124 (Del. Ch. 2004).

⁵⁹ An example of a generous advancement clause might look as follows: “Expenses, including attorneys’ fees, reasonably incurred by an Indemnitee in defense or settlement of any claim that may be subject to a right of indemnification hereunder shall be advanced by the partnership prior to the final disposition thereof upon receipt of an undertaking by or on behalf of the Indemnitee to repay such amount to the extent that it shall be determined ultimately that such Indemnitee is not entirely to be indemnified hereunder.” Note, some advancement clauses require the consent of a third party, like a general partner, before the business organization will advance fees.”

⁶⁰ Delphi Easter Partners Ltd. Partnership v. Spectacular Partners, Inc., 1993 WL 328079 (Del Ch. Aug. 6, 1993). The Chancery Court stated that Delaware limited partnership law “defers completely to the contracting parties to create and delimit rights and obligations with respect to indemnification and advancement of legal fees.”

⁶¹ The following is sample language allocating primary indemnification responsibility to a joint venture:

The Company hereby acknowledges that the directors, shareholders, principals, managers, members, officers, employees, consultants, advisers or agents of the Investor Entities or their respective Affiliates (the “Indemnified Parties”), may have certain rights to indemnification, advancement of expenses

E. Drafting Considerations.

1. If more than one indemnitor, the draft should consider prioritizing indemnification obligations among indemnitors.

2. If expenses are to be advanced, consider which class of indemnitees are entitled to advancement and the discretion the final arbiter has in granting or denying advancement, if not automatic.

3. Limitations on indemnity and advancement should be drafted clearly, explicitly and unambiguously. Any lack of clarity will be construed against the indemnitor and in favor of the indemnitee.

VI. SERIES LLCs - JUST SAY NO FOR NOW

A. Background.

In some states, their LLC statute permits LLCs to have separate, identified “series” of LLC interests and associated assets that, subject to certain conditions, provides the debts, liabilities, obligations and expenses relating to one series of the LLC may not be enforced against the assets of the LLC generally or the assets associated with any other series of the LLC.⁶² Note that in Delaware, while each series is vested with a liability shield akin to that associated with separate legal entities, the Act does not indicate that each series is a separate legal entity.⁶³ Series LLCs were traditionally used in the organization of mutual and hedge funds; broader applications are now being considered. While some may argue that a series LLC can be a useful vehicle in certain circumstances and can avoid the inefficiencies of forming

and/or insurance provided by the Investor Entities, and certain of their affiliates (collectively, the “Fund Indemnitors”). The Company hereby agrees:

(i) that it is the indemnitor of first resort (i.e., its obligations to the Indemnified Parties are primary and any obligation of the Fund Indemnitors to advance expenses or to provide indemnification for the same expenses or liabilities incurred by the Indemnified Parties, as applicable, are secondary);

(ii) that it shall be required to advance the full amount of expenses incurred by Indemnified Parties and shall be liable for the full amount of all expenses to the extent legally permitted and as required by the terms of this Article ___ without regard to any rights the Indemnified Parties may have against the Fund Indemnitors; and

(iii) that it irrevocably waives, relinquishes and releases the Fund Indemnitors from any and all claims against the Fund Indemnitors for contribution, subrogation or any other recovery of any kind in respect thereof.

The Company further agrees that no advancement or payment by the Fund Indemnitors on behalf of the Indemnified Parties with respect to any claims for which the Indemnified Parties has sought indemnification from the Company shall affect the foregoing and the Fund Indemnitors shall have a right of contribution and/or be subrogated to the extent of such advancement or payment to all of the rights of recovery of the Indemnified Parties against the Company. The Company agrees that the Indemnified Parties and the Fund Indemnitors are express third party beneficiaries of the terms of this Article ___.

⁶² See Delaware: 6 Del. C. § 18-215; Illinois: 805 ICLS 180/37-40; Iowa: Iowa Code § 490A.305; Nevada: NRS § 86.296.3; Oklahoma: 18 Okla. Stat. § 18-2054.4.B; Tennessee: Tenn. Code Ann. § 48-249-309; Texas: V.T.C.A. Bus. Org. Code § 101.601; Utah: Utah Code Ann. § 48-2C-606.

⁶³ 6 Del. C. § 18-201(b).

multiple entities, because of the many practical issues and concerns that remain outstanding today, including whether an “inter-series” liability shield will be respected outside of a state having series legislation and the tax complexities of the structure, the use of series LLCs should be extremely limited.

B. Significant Open Issues Relating to Series LLCs.

1. Federal Tax Treatment.

a. The tax treatment of series LLCs is largely unresolved. In determining the federal tax classification of a series LLC, the threshold inquiry is whether each series within a LLC constitutes a separate business entity for federal tax purposes. In this regard, entity status under state law may be highly relevant, though not determinative. In other words, a partnership may exist for federal tax purposes even without the existence of a distinct state law entity. On the other hand, whether a state law entity exists, the existence of an entity for federal tax purposes is often, but not always, inferred.

(i) Rev. Rul. 55-39, 1955-1 C.B. 403. The Internal Revenue Service ruled that the investment by a partnership of a member’s contributed capital in investments of his own choice and for his own account resulted in the deemed withdrawal of those securities from the partnership.

(ii) The Tax Court has recognized that the several series of an investment fund may be considered distinct taxable entities⁶⁴ and so has the IRS, repeatedly.⁶⁵

(iii) A leading commentator has concluded that the position taken in the investment fund private letter rulings and the principle of Rev. Rul. 55-39, 1955-1 C.B. 403 make it likely that the IRS will take the same view in the case of a LLC series.⁶⁶

b. If each series is treated as a separate business entity for federal tax purposes, then it appears that each series is an “eligible entity” that may elect its tax classification under the check-the-box regulations.⁶⁷ The check-the-box regulations classify organizations, other than non-business trusts, as corporations, partnerships, or disregarded entities.

c. The federal tax consequences of investing in a series LLC remain unclear. Some of the unresolved issues are as follows:

⁶⁴ See *National Securities Series-Industrial Stock Series v. Commissioner*, 13 T.C. 884 (1949), acq., 1950-1 C.B. 4.

⁶⁵ See e.g., PLR 200803004 (the separate portfolios of a series LLC will be individually classified as a partnership, disregarded entity, or association); PLR 200544018. (The separate portfolios of a series business trust are classified as business entities and not trusts; and each one with two or more members that does not elect association classification is a partnership); PLR 200303019; PLR 9847013 (if each series is treated as a separate trust and the creditors of one series of the trust may not reach the assets of any other series of the trust, each is a separate entity for tax purposes.)

⁶⁶ See *Bishop and Kleinberger, Limited Liability Companies* ¶ 2.11 (May 2006).

⁶⁷ See Treas. Reg. Section 301.7701-2.

(i) IRC § 6031(a) requires that “every partnership (as defined in IRC § 761(a))” file an information return. Is the master entity a single taxpayer filing one information return or must each series file a separate information return? The statute of limitations on assessments remains open if there is a failure to file a required information return.

(ii) May (or must) each series obtain its own federal tax identification number?

(iii) May one series elect to be treated as a corporation under the check-the-box regulations?

(iv) What if a member contributes an appreciated asset to a series in which the member has little or no interest and the member receives an interest in a different series to which the member makes no contribution?

(v) How are shifts in percentage ownership interests among the various series treated? For example, what if a member’s percentage interest in Series X is reduced by 10% in exchange for an economically equivalent percentage interest increase in Series Y?

(vi) What if one series sells relinquished property and another series acquires replacement property in a transaction intended to qualify as an IRC § 1031 exchange?

(vii) Can only some, but not all, series make IRC § 754 elections?

(viii) How is the partnership year determined under IRC § 706?

(ix) How are the TEFRA audit rules applied?

2. State Income Tax Treatment.

a. The California Franchise Tax Board has stated its position that each component series of a series LLC, “for example a Delaware Series LLC,” is a separate LLC and must file its own Form 568, Limited Liability Company Return of Income, and pay its own separate LLC annual tax and fee if it is registered or doing business in California, and if (1) the holders of interest in each series are limited to the assets of that series upon redemption, liquidation or termination, and may share in the income only of that series, and (2) under state law, the payment of the expenses, charges, and liabilities of each series is limited to the assets of that series.⁶⁸ One interpretation of the California Franchise Tax Board Position is illustrated in Exhibit 7 and referred to as the “CAFTB Test.”

⁶⁸ California 2008 Limited Liability Company Tax Booklet, p. 6, Section F; FTB Pub. 3556 p. 4 (Rev. 7-2008). The FTB stated that it was applying the principle of National Securities Series, supra. Franchise Tax Board Tax News, March/April 2006, p.3. See Banoff and Lipton, Shop Talk, California Refines Its Tax Treatment of Series LLCs, 106 Journal of Taxation 316 (May, 2007) for an excellent discussion of the issues raised by the California Franchise Tax Board’s conditions for classifying a series LLC as a separate entity. See also,

b. Consistent with the same issues that arose when LLCs first came on the scene, will the states automatically follow the federal tax treatment of the series? And since so far there is no federal pronouncement, what paradigm will the states follow?

c. Will states imposing various forms of entity-level taxes follow California's lead and attempt to impose their tax on each series?

d. If income tax nexus is established over, say, Series A, will that automatically subject the entire LLC and the rest of its series to that state's taxing jurisdiction? What about nexus over the member(s) of Series B, C and D?

3. Foreign State's Recognition of Internal Shield.

a. Another major open issue is the effectiveness of the internal liability shield in a foreign state that does not itself have series legislation. This is not unlike the issue that practitioners grappled with when LLC statutes were first passed and many states were slow to follow adoption, namely whether states without LLC Acts would recognize the limited liability of a foreign LLC.

b. Some statutes with series provisions have specific provisions that recognize the internal liability shield of a foreign LLC. *E.g.*, 805 ILCS § 80/37-40(A); OKLA. STAT. § 2054.4.M. The Delaware series provision seems to expressly recognize the internal shield of a foreign LLC.⁶⁹ The Illinois statute expressly provides that Illinois will recognize the internal liability protections.⁷⁰

c. Recognition of the internal liability protection is to be distinguished from the general governing law provision that the law of the state of organization of a foreign LLC governs its organization and internal affairs and the liability of its members and managers. *E.g.*, DEL. CODE ANN. tit. 6, § 18-901(a)(1). It is not clear that the general provision of the LLC acts of other states recognizing that the law of the state of foreign organization governs the liability of "its members and managers" has the same result as the specific provisions of the series statutes. See RE-ULLCA § 801 COMMENT: "This provision does not pertain to the 'internal shield of a foreign 'series' LLC, because those shields do not concern the liability of members or managers for the obligation of the LLC. Instead those shields seek to protect specified assets of the LLC (associated with one series) from being available to satisfy specified obligations of the LLC (associated with another series)."

Stein, *California's Treatment of a Foreign Jurisdiction's Series LLCs*, Business Entities May/June 2008 p. 16, 19-21, 64.

⁶⁹ Del. Code Ann. Tit. 6, § 18-215(n)

⁷⁰ Section 805 ILL. COMP. STAT.180/37-40(o) provides: "Unless otherwise provided in the operating agreement, the debts, liabilities and obligations incurred, contracted for or otherwise existing with respect to a particular series of such a foreign limited liability company shall be enforceable against the assets of such series only, and not against the assets of the foreign limited liability company generally or any other series thereof and none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to such a foreign limited liability company generally or any other series thereof shall be enforceable against the assets of such series."

4. Bankruptcy.

a. May a separate series that is insolvent file a bankruptcy petition separate and apart from the LLC? At this time, it is unclear whether a “series” that is not defined as an “entity” may be a “person” permitted to file for bankruptcy protection under the bankruptcy code.

(i) Petition may be filed by any “person.” 11 U.S.C. § 109 (a).

(ii) “Person” includes an individual, partnership, or corporation. 11 U.S.C. § 101(41), but does not include an estate or trust (other than a business trust). 11 U.S.C. § 101(15) (“entity” includes person, estate, trust, governmental unit, and United States trustee.”)

(iii) In addition to those enumerated as eligible, “other similar entities are as well.” See *In re ICLNDS Notes Acquisition, LLC*, 259 B.R. 289, 292 (Bankr. N.D. Ohio 2001) holding a LLC eligible because it draws its characteristics from both corporations and partnerships and, therefore, “is similar enough to those entities to be eligible.”

(iv) “Corporation” includes, among others, a partnership association organized under a law that makes only the capital subscribed responsible for the debts of the association (11 U.S.C. § 101(9)(A)(ii)), includes unincorporated company or association (11 U.S.C. § 101(9)(A)(iv)) and a (v) business trust (11 U.S.C. § 101(9)(A)(v)), but excludes a limited partnership (11 U.S.C. § 101(9)(B)).⁷¹

(v) “Partnership” is not defined, but 11 U.S.C. § 723 sets forth the rules with respect to partnerships – for example how the partners’ contribution obligations are to be handled. Thus, it seems clear that the defining characteristic of a “partnership” is the vicarious liability and obligation to contribute that does not exist in limited liability entities.

b. Based on the definition, a LLC should be treated as a “corporation” under the Bankruptcy Code, nonetheless, it is not clear that a “series” shall be.⁷²

⁷¹ According to the legislative note: The definition of “corporation” in paragraph (8) is similar to the definition in current law, section 1(8) [section 1(8) of former title 11]. The term encompasses any association having the power or privilege that a private corporation, but not an individual or partnership, has; partnership associations organized under a law that makes only the capital subscribed responsible for the debts of the partnership; joint-stock company; unincorporated company or association; and business trust. “Unincorporated association” is intended specifically to include a labor union, as well as other bodies that come under that phrase as used under current law. The exclusion of limited partnerships is explicit, and not left to the case law.

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⁷² See, Kennedy, Countryman & Williams, *Kennedy, Partnerships, Limited Liability Entities and S Corporations in Bankruptcy* § 2.12 (2002); Ribstein and Keatinge, *Ribstein and Keatinge on Limited Liability Companies* § 14:4 (December, 2006). See also *In re 4 Whip, LLC*, 332 B.R. 670 (Bkrcty. D. Conn., 2005) holding even a *de facto* (imperfectly formed) LLC may be a debtor in bankruptcy.

VII. AMENDMENT CLAUSES

A. Background

Partnership agreements and limited liability company operating agreements are “contracts” and require **all** partners and members to be parties to them, otherwise, a person who is not a signatory to the agreement may not be considered or admitted as a partner or member. There is nothing in most partnership and LLC Acts that prescribe the conditions under which a partnership agreement or LLC Agreement can be amended. Because such agreements are treated as contracts among the owners, unless the agreement provides otherwise all of the owners must consent to an amendment, no matter how insignificant because contracts can only be amended by all of the parties thereto unless the agreement provides otherwise. Accordingly, careful thought should be given to the terms by which a partnership or an operating agreement can be amended.

B. Amendment Concepts

1. Because limited partnerships are generally controlled by a general partner, an amendment of the limited partnership agreement almost always requires the consent of the general partner and some percentage of the limited partners, which percentage vote is often based on the amount of capital invested by the limited partners. Likewise, in a manager-managed LLC controlled by managers, the consent of one or more managers is generally required to amend a LLC agreement along with the consent of a certain percentage of members. Most organizations wish to retain flexibility to amend their charter documents to respond to an ever changing business or market place and not be “held up” by a small minority who refuses to change, but at the same time, passive owners, especially those with a minority interest, do not wish to see their economic arrangement changed at the whim or capriciousness of other owners.

2. Rarely should entities with multiple owners, especially passively owned partnerships and LLCs, require all of the owners to consent to an amendment. And while rudimentary amendments might only require a majority vote, practitioners should consider the types of amendments that require a supermajority vote. For example, amendments may generally require the vote of the general partner and a majority of limited partners but some major changes, such as a change in the “purpose” of the entity, require a supermajority vote. Further, special limited partners like foundations or ERISA organizations may want to have a veto vote over the actions that might jeopardize their tax status.⁷³

⁷³ The followings is an example of a robust amendment section:

(a) Subject to paragraph __.__(b) this Agreement may be amended only with the written consent of the General Partner and a Majority in Interest of the Limited Partners.

(b) Notwithstanding paragraph __.__(a): (i) no amendment to Article __ may be made without the consent of each Governmental Plan Partner, Private Foundation Partner or BHC Partner who would be adversely affected by such amendment, and no amendment to Paragraph _____ may be made without the consent of each ERISA Partner who would be adversely affected by such amendment (ii) no amendment to paragraph __.__(c) may be made without the consent of a Majority in Interest of those Limited Partners who have notified the General Partner in writing (in their subscription materials or otherwise) that they are exempt from taxes under the Code (including those Limited Partners that have notified the General Partner in writing (in their subscription materials or otherwise) that their interests are at least partially owned by any tax exempt person), (iii) the General Partner may amend this Agreement

3. Even if a majority vote of limited partners is permitted to amend a limited partnership agreement, it is not uncommon to draft a caveat that prevents a majority from oppressing the minority. For example, an amendment clause might require the consent of any limited partner adversely affected by an amendment if the other limited partners are not treated similarly. This would prevent a majority of LPs, for example, from amending the partnership agreement to reduce the interest of another partner.⁷⁴ Exceptions to majority votes should be carefully drafted. For example, practitioners should refrain from drafting a generic amendment clause that requires a member to consent to an amendment if he or she is “adversely affected.” In a recent case where a LLC agreement provided that amendments could not be made that adversely affected a member without that member’s consent, the court held that an amendment was invalid notwithstanding that such amendment did not specifically alter the member’s percentage interest in profits and distributions.

4. Many agreements permit general partners and managers in limited circumstances to amend partnership and operating agreements without the consent of the other equity holders, for example, to resolve “ambiguities” or certain errors.

VIII. MISCELLANEOUS FEDERAL INCOME TAX CONSIDERATIONS

For purposes of the discussion under this title heading, the focus will be on LLCs rather than partnerships, but many of the principles addressed herein apply equally to limited and general partnerships.

without the consent of the other Partners to (A) reflect changes validly made in the membership of the Partnership and the capital contributions of the Partners, (B) comply with applicable law (provided such amendment does not materially and adversely affect any of the Limited Partners), or (C) correct a manifest error in, supply a missing term or provision to, or resolve an ambiguity in the existing terms and provisions of this Agreement (provided such amendment does not adversely affect any of the Limited Partners), (iv) no amendment to this Agreement may modify any provision requiring the consent of more than a Majority in Interest of the Limited Partners without the consent of such higher Percentage in Interest, and (v) no amendment that would adversely affect only a single Limited Partner or similarly-situated group of Limited Partners (other than an effect based on such Limited Partner’s Partnership Percentage or group of Limited Partners’ Partnership Percentages) may be made without the written consent of such Limited Partner or Limited Partners.

(c) Notwithstanding paragraphs ___(a) and ___(b), no amendment of this Agreement may modify the method of making Partnership allocations or distributions, modify the method of determining the Partnership Percentage of any Partner, reduce any Partner’s Capital Account, modify any provision of this Agreement pertaining to limitations on the liability of the Limited Partners, or change the restrictions contained in this paragraph ___(c), unless each Partner materially and adversely affected thereby in a manner different than the other Partners has expressly consented in writing to such amendment.

⁷⁴ See for example, *IH Riverdale, LLC v. McChesney Capital Partners, LLC*, 666 S.E.2d 8 (Ga. App. 2008) where the court held that amendment of a LLC operating agreement to eliminate a minority member’s 5% “guaranty profit distribution” was valid because the agreement permitted amendment by members holding at least a majority interest, defined as 80% of the aggregate ownership interest, and the amendment was approved by members owning 94.68% of the LLC’s ownership interest. The court concluded that the operating agreement was clear and unambiguous, that the guaranty distribution provision was not included in “major decisions” requiring unanimous consent, and that parol evidence could not be used to construe the contract.

A. Compensation Issues

1. Operating/non liquidating distributions. The timing of distributions depend on the terms of the Operating Agreement.⁷⁵ Generally, most states preclude distributions that otherwise make a LLC insolvent.⁷⁶ Types of interim distribution arrangements include:

a. A special “tax distribution.” Because income of a LLC flows through to the members who report the income on their tax returns, many operating agreements require LLCs to make distributions sufficient to cover tax liabilities attributable to the members’ allocable charge of LLC income. The tax provision can be as simple as requiring that there be an annual distribution to each owner equal to a specified percentage of the taxable income allocated to that owner or as complicated as to require consideration of the marginal tax bracket of each owner, whether the owner has been allocated losses in the past, and whether the owner’s distributive share is ordinary income or capital gain.

b. Guaranteed Payments and Draws. At times, a LLC, particularly one in which the owners provide services to the LLC, will provide for regular distributions of cash similar to the wages that would be paid to an employee. Such regular distributions may be characterized as “draws” or advances against the owner’s share of the profits of the LLC or may be absolute distributions. If they are draws or advances, they will be subject to adjustment at the end of the year when the owner’s share of profits is determined. Because members of LLCs are not treated as employees for tax purposes, there is no withholding tax.⁷⁷

c. Preferred Distributions. Where some members contribute cash or property to a LLC and others contribute services, the cash or property contributor may require the value of his contribution to be returned first, sometimes within a preferred return.

d. “Default” Distributions. Most statutes do not set forth rules with respect to when interim distributions should be made, leaving the determination of when, or if, distributions will be made before the liquidation of the LLC. Most statutes provide rules for how the distributions will be shared if the LLC agreement does not provide an alternative rule, often decreeing that distributions will be shared in the same manner as the profits of the LLC.⁷⁸ Accordingly, it is imperative that members set forth in an agreement how profits and distributions will be shared.

2. **Liquidating Distributions.**

Many LLC agreements provide for the assets of the LLC to be distributed on liquidation, in proportion to the owners’ capital accounts or the owners’ positive capital accounts. The agreement among the owners may allocate the profits and losses among the members in any manner that they desire, but the allocations will not be respected for tax purposes unless the allocation actually determines the amount of money that the owners will get

⁷⁵ See Cal. Corp. Code § 17250.

⁷⁶ See Cal. Corp. Code § 17254(a). California also applies a balance sheet test precluding distributions that would result in a LLC’s total assets being less than its total liabilities.

⁷⁷ See Rev. Rul. 69-184, 1869-1 C.B. 256.

⁷⁸ See Cal. Corp. Code § 17250.

on liquidation. When liquidating distributions are made in accordance with capital accounts, it is important that the draftsman understand how the allocations are distribution provisions impact the capital accounts.

3. Profits Interest

a. The LLC may grant an interest in future profits without giving that grantee a current capital account. Such an interest is referred to as a “profits interest.” A service performer is treated as receiving a “pure” profits interest if, upon a hypothetical liquidation of the partnership immediately after the issuance of the interest, the service performer would not receive a distribution.⁷⁹

b. As a general rule, when a service provider receives property of any kind, including stock or interests in a LLC, for services, the recipient is required to include the fair market value of that property in income unless the property is subject to a risk of forfeiture (such as an obligation to sell the property back to the person from whom it was received for less than fair market value). It is possible to avoid the current recognition of income by giving a service provider a profits interest.

c. According to Rev. Proc. 93-27, the receipt of a partnership profits interest for services is not a taxable event so long as the person receives that interest either as a partner or in anticipation of becoming one. The procedure does not apply, however, if:

(i) The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(ii) The partner disposes of the profits interest within two years of its receipt; or

(iii) The profits interest is limited partnership interest in a publicly traded partnership under § 7704.

d. On the day an owner is admitted with a profits interest, the owner has a capital account of zero. In other words, the value of the other owners’ capital accounts should equal the value of all of the LLC assets. After admission, the owner with a profits interest will share in profits and losses; that share will increase or decrease the owner’s capital account like the other owners, so that after a period of time an owner with a profits interest will have a capital account that reflects the profits and losses incurred after the owner’s admission. Note, notwithstanding that Rev. Proc. 93-27 does not require the filing of a § 83(b) election to avoid

⁷⁹ Rev. Proc. 93-27, 1993-2 C.B. 343. For example, if a limited partnership agreement provides that profits from the partnership are allocated 20% to the general partner and 80% to the limited partner and upon liquidation the partnerships assets are distributed to the partners in accordance with their capital accounts, and the limited partner contributed \$100 and the general partner contributes services, the general partner will be deemed to have received a 20% profits interest because, if the partnership were to liquidate the day after formation, the general partner would be entitled to nothing.

income recognition when a profit interest vests, many practitioners recommend profits interest recipients to file § 83(b) elections in case they do not meet the Rev. Proc. 93-27's prerequisites.

A profits interest may not include the appreciation in partnership assets at the time the interest is issued. If the interest entitles the recipient to share in pre-issuance appreciation, it will be regarded as a capital interest and thus will be taxable upon receipt.

It is not uncommon for a partnership to have substantially appreciate assets at the time the profits interest is issued to one or more service performers. In order to fall within the protection of Rev. Proc. § 93-27, it will be necessary for such partnerships to "book-up" the capital accounts pursuant to Treas. Reg. § 1.704-1(b)(2)(f) immediately prior to the issuance of the profits interest. Since such book-up must be based on the fair market value of the partnership's assets, effectuating the book-up can be difficult and expensive, especially if profits interest are issued at different times (thus necessitating multiple book-ups).

In Rev. Proc. 93-27, the IRS announced that it will not treat the receipt of a pure profits interest in exchange for services rendered to or for the partnership in a partner capacity or in anticipation of becoming a partner as a taxable event for the partner or the partnership if the profits interest does not relate to a substantially certain or predictable stream of income, such as income from high-quality debt securities or a high-quality net lease; the partner does not dispose of the profits interest within two years of receipt; and the profits interest is not in a "publicly traded partnership" within the meaning of § 7704(b). The application of Rev. Proc. 93-27 is limited to a person who receives a profits interest.

4. Issuance of a Partnership Capital Interest for Services.

Generally, a service performer will be treated as receiving a "capital interest" in a partnership if, on the date the capital interest is received, the service performer would receive a distribution with respect to the partnership's assets if the partnership were liquidated.⁸⁰

The transfer of a capital interest in a partnership in exchange for services is a taxable transfer of property subject to the rules of § 83.⁸¹

a. Tax Results if the Capital Interest is Unrestricted at the Time of Transfer.

(i) The transfer of the capital interest will be a taxable event. The Service performer will immediately recognize income in the amount of the fair market value of the capital interest, reduced by the amount, if any, the service performer pays for the interest. All of this income will be ordinary compensation income, subject to wage withholding and payroll taxes if the service performer is an employee.⁸²

⁸⁰ Rev. Proc. 93-27, 1993-2 CB 343.

⁸¹ Treas. Reg. § 1.721-1(b)(1).

⁸² Treas. Reg. § 1.721-1(b)(1).

(ii) It appears that the transfer of a capital interest will cause the partnership to recognize gain from the issuance, especially if the partnership has appreciated assets. Under general principles of taxation, the satisfaction of an obligation with appreciated property is a taxable event. Therefore, the issuance of the capital interest could be viewed to involve a deemed transfer of an undivided interest in the partnership's assets to the service performer followed immediately by the recontribution of such assets to the partnership. This treatment should mark-to-market the tax basis of the assets deemed transferred to the service performer and the service performer should enjoy the benefit of the basis adjustment.

b. Tax Results if the Capital Interest is Restricted at the Time of Transfer.

(i) If the capital interest is subject to a substantial risk of forfeiture, then the service performer will not be taxed upon the issuance of the interest. However, the service performer may elect, under § 83(b) of the Code, to be taxed currently on the fair market value of the issued capital interest.

(ii) If a § 83(b) election is not made at the time the capital interest vests in the future, the service performer will recognize income in the amount of the fair market value of the capital interest on the date of vesting (less any amount the service performer paid for the interest). The gain will be ordinary compensation income.

(iii) Under Treas. Reg. 1.83-1(a)(1), the service performer will presumably not be recognized as a partner in the partnership for tax purposes until the service performer's capital interest vests. Until such time, distributions with respect to the partnership interest before the restrictions lapse should be treated as compensation paid by the partnership.

(iv) If a § 83(b) election is made, the § 83(b) election will cause the service performer to recognize gain immediately upon the issuance of the capital interest (fair market value over amount paid by the service performer). The service performer is regarded as the "owner" of the capital interest once a § 83(b) election is made and the service performer satisfies the traditional requirements to become a partner for tax purposes.

B. Self Employment Tax

1. The Service has held that a partner may not be an employee of a partnership.⁸³ Thus a member of a LLC taxes as a partnership cannot also be a tax employee of the LLC and is not subject to employee tax withholdings.

2. § 1402(a) defines net earnings from self-employment. That definition includes a partner's distributive share of ordinary income from the trade or business carried on by the partnership – excluding income derived from rental real estate. § 1402(a)(13) excludes the distributive share of any item of income or loss of a limited partner other than guaranteed payments for services rendered by the partner to the partnership.

⁸³ Revenue Rulings 69-144, 1969-1 C.B. 115 and 70-440, 1970 C.B. 209.

a. If the entity is engaging in an active trade or business, the potential social security and hospital insurance tax or self-employment income tax liability of the owners on their share of the distributive income of the entity will become an issue.

b. Up to the extent the member is treated as having Net Earnings from Self-Employment (NESE), the member is subject to various self-employment taxes. For 2009, self-employment taxes are imposed on net earnings from self-employment at the rate of 15.3% on the first \$106,800 and 2.9% on amounts in excess of \$106,800.

c. Under § 1402(a)(13), a limited partner in a limited partnership will not have self-employment income with respect to the share of the limited partnership's distributive income attributable to his or her limited partnership interest, but will have self-employment income to the extent he or she receives a guaranteed payment under § 707(c) for services rendered to the limited partnership. § 1402(a)(13).

d. A general partner in a limited partnership will have self-employment income with respect to the share of the limited partnership's income attributable to his or her general partnership interest. § 1402(a).

e. However, it is possible for the same individual to have both a general partnership interest (which may be a very small percentage) and a limited partnership interest (which may be a much larger percentage) in the same limited partnership and thereby bifurcate his or her income for self-employment tax purposes. § 1402(a)(13). The distributive share of the limited partnership's income attributable to the partner's limited partnership interest will not be self-employment income. § 1402(a)(13).

f. The issue is less clear in the case of a LLC. A member of a manager-managed LLC who is not a manager and is not performing any services on behalf of the LLC should not have self-employment income. On the other hand, a member-manager of a manager-managed LLC or a member of a member-managed LLC would presumably have self-employment income. While theoretically it should be possible for a member-manager to have some of his or her income treated as non-self-employment income to the extent it represents a return on his or her services, there is no authority as yet to substantiate such a position.

g. The IRS has issued two sets of proposed regulations dealing with the self-employment tax as it applies to LLCs.⁸⁴

h. Under the existing regulations, it is possible to bifurcate a partner's share of the partnership's net income into self-employment income and non-self-employment income if the partner owns both a general partnership interest and a limited partnership interest. Under the proposed regulations, a member of a LLC will be able to bifurcate the member's share of the LLC's income under certain circumstances.

⁸⁴ See Prop. Treas. Reg. § 1401(a)-18 (issued December 29, 1994), replaced by Prop. Treas. Reg. § 1.1402(a)-2 (issued January 13, 1997).

(i) Until clarified by either legislation or regulations, the use of a limited partnership or S corporation may provide more certainty when it is desired to avoid self-employment income tax.

(ii) Fortunately, the self-employment tax may not be an issue in those family LLCs in which the only assets are passive investments, such as marketable and nonmarketable securities and passive real estate investments.

C. IRC § 409A

1. IRC § 409A dramatically changes the structure and operation of deferred compensation plans, and even imposes a twenty percent additional tax on deferred amounts that do not meet the new requirements imposed by the Act. In December, 2004, Treasury issued its first round of guidance (Notice 200501). IRC § 409A generally applies with respect to amounts deferred after December 31, 2004. However, it can be applicable to deferred amounts that were invested as of December 31, 2004, regardless of when the deferral election was made, and in that respect had significant potential for retroactive application. IRS Notice 2005-1 clarifies that nothing needed to be done by the end of 2004 to comply with the new law, and explains how to implement the new requirements during 2005. Notice 2005-1 also provides other guidance that will assist plan sponsors in complying. Guidance under IRC § 409A since Notice 2005-1 has not addressed LLCs or other partnership.

2. In general IRC § 409A provides that all amounts deferred under a non-qualified deferred compensation plan are currently includible in gross income to the extent that they are not subject to a substantial risk of forfeiture, unless the plan meets certain new restrictions as to timing of deferral elections and distribution elections, permissible distribution events, acceleration of payments and subsequent deferral elections. A twenty percent additional tax on the payment recipient and interest at a heightened rate in addition to tax at ordinary income tax rates is imposed on payments recipients with respect to whom there is a failure to comply with the requirements of IRC § 409A.

IX. MISCELLANEOUS NON TAX CONSIDERATIONS

A. Assignment Clauses – Rights to Transfer Limited Partnership and LLC Membership Interests. The focus of this discussion is on the rights of a limited partner of a limited partnership to withdrawal from a limited partnership and assign its limited partnership interest. The rules that apply to limited partnerships generally apply to limited liability companies.

1. **Rights to Transfer Limited Partnership Interests.** The right to withdraw from a limited partnership is almost always strictly prohibited.⁸⁵ The right of a limited partner to

⁸⁵ § 17-603 of the Delaware Revised Uniform Limited Partnership Act, 6 Del. C. § 17-101 et. Seq. (the “DRULPA”) provides in pertinent part that a limited partner may withdraw from a limited partnership only at the time or event specified in the partnership agreement and that unless the partnership agreement provides otherwise, a limited partner may not withdraw prior to the dissolution and winding up of the limited partnership. Most limited partnerships prohibit limited partners from withdrawing prior to the partnership’s winding up of its affairs. See also, Cal. Corp. Code § 15906.01(a).

assign its limited partnership interest to a third party in a secondary sale is often limited by the terms of the limited partnership agreement.

a. Assignment of Limited Partnership Interests. Generally, a limited partnership interest is assignable in whole or in part unless otherwise provided in the partnership agreement.⁸⁶ An assignee of a limited partnership interest may be substituted as a limited partner to the extent the limited partnership agreement so provides and, unless otherwise provided in the partnership agreement, the substituted limited partner is liable for the capital contribution obligations of the assignor⁸⁷ and the assignor is not released from the liability for such obligations if the assignee becomes a limited partner and assumes the obligations.⁸⁸

b. Partnership Agreements Generally Restrict Assignments. While the default provisions of the DRULPA provide for assignability of limited partnership interests, very few private fund limited partnership agreements permit assignments.

(i) Typical restriction language is as follows:

“Transfer by Limited Partner. No Limited Partner shall sell, assign, pledge, mortgage, or otherwise dispose of or transfer its interest in the Partnership, directly or indirectly, without the prior written consent of the General Partner, which consent may be granted or denied in the sole discretion of the General Partner.”

(ii) Limited partnership agreements may provide for exceptions to the limitation on transfers, such as an assignment to an affiliate of the limited partner. Even though transfers may be subject to the discretionary consent of the general partner, to set expectations of limited partners and to reduce claims by prospective assignors that the general partners’ withholding of consent is arbitrary and capricious, the general partner will often set forth in the limited partnership agreement the requirements that must be satisfied before a consent for assignment is considered. The applicable provision in the limited partnership agreement might look as follows:

“Requirements for Transfer. No transfer or other disposition of the interest of a Limited Partner shall be permitted until the General Partner shall have received an opinion of counsel satisfactory to it (or waived such opinion requirement) that the effect of such transfer or disposition would not:

⁸⁶ § 17-202(a)(1) of the DRULPA and § 15907.01 of the Cal. Corp. Code.

⁸⁷ § 17-704 of the DRULPA and § 15907.02 (g) and (h) of the Cal. Corp. Code..

⁸⁸ § 17-704 of the DRULPA. Although the DRULPA does not specifically state that the assignor’s continuing obligation can be modified by the terms of the partnership agreement, there is nothing in the Act that would preclude the partnership agreement to allow the general partner to release the capital contribution obligations of the assignor if the assignee assumes them. See § 17-1101(c) of the DRULPA where it states that the policy of the Act is to give maximum effect to the principle of freedom of contract and the enforceability of partnership agreements.

- (a) result in the Partnership's assets being considered, in the opinion of counsel for the Partnership, as "plan assets" within the meaning of ERISA, or any regulations proposed or promulgated thereunder;
- (b) result in a violation of the Securities Act or any comparable state law;
- (c) require the Partnership to register as an investment company under the Investment Company Act;
- (d) require the Partnership, the General Partner, or any member of the General Partner to register as an investment adviser under the Investment Advisers Act of 1940, as amended;
- (e) result in a termination of the Partnership for federal income tax purposes pursuant to Section 708 of the Code, unless such termination would have no adverse effect upon the Partnership or any Partner; or
- (f) cause the Partnership to be a "publicly traded partnership" as such term is defined in Section 7704(b) of the Code.⁸⁹

Such legal opinion shall be provided to the General Partner by the transferring Limited Partner or the proposed transferee. Any costs associated with such opinion shall be borne by the transferring Limited Partner or the proposed transferee. Upon request, the General Partner will use its good faith efforts to provide any information possessed by the Partnership and reasonably requested by a transferring Limited Partner to enable it to render the foregoing opinion. Notwithstanding any provision of this Article ___ to the contrary, the General Partner may, in its sole discretion,

⁸⁹ Note, if too many limited partnership interests are transferred in any period, the limited partnership could be treated as a "publicly traded partnership" ("PTP") under IRC § 7704. Because publicly traded partnerships are generally treated as corporations for federal income tax purposes, classification as a PTP could have significant adverse tax consequences to the partnership and its partners. Accordingly, general partners must consider the PTP rules before consenting to an assignment. Although the determination of PTP status ultimately depends on the facts and circumstances, any transfer that is not eligible for one of several "safe harbors" provided in the Treasury regulations could increase the likelihood that the partnership will be classified as a PTP. The most commonly relied upon safe harbor is the "private placement" safe harbor which exempts partnerships where all of the interests were exempt from registration under the Securities Exchange Act of 1933 (i.e. private placement) and the partnership has no more than 100 partners. Treas. Reg. § 1.7704-1(h). Many funds do not satisfy the 100 partner limitation and seek to satisfy the "2%" test whereby transfers of partnership interests that don't otherwise meet a safe harbor do not exceed 2% of the total percentage interests in the partnership's capital or profits. See Treas. Reg. § 17704-1(j). In applying the percentage thresholds contained in the safe harbors, partnership interests owned by the GP or persons related to the GP are not treated as outstanding if the GP and such related persons own an aggregate partnership interest of more than 10%. See Treas. Reg. § 1.7704-1(k)(1). For this purpose, a person may be considered related to the GP if the person owns more than 50% of the GP's stock, the GP owns more than 50% of the ownership interests in the person, or the person is an entity having the same controlling owner(s) as the GP. Certain constructive ownership rules apply.

waive the requirement of an opinion of counsel provided for in this Section ____.”

(iii) Because of the limited rights of an assignee,⁹⁰ most assignees of limited partnership interests in the secondary market will demand that they be substituted as a limited partner for the assignor. Such substitution is usually at the discretion of the general partner and generally does not relieve the assignor of its capital call liabilities. A common substitution section might be drafted as follows:

“Substitution as a Limited Partner. A transferee of a Limited Partner’s interest pursuant to this Article __ shall become a substituted Limited Partner only with the consent of the General Partner, which consent may be granted or denied in the sole discretion of the General Partner, and only if such transferee (a) elects to become a substituted Limited Partner and (b) executes, acknowledges and delivers to the Partnership such other instruments as the General Partner may deem necessary or advisable to effect the admission of such transferee as a substituted Limited Partner, including, without limitation, the written acceptance and adoption by such transferee of the provisions of this Agreement. No assignment by a Limited Partner of its interest in the Partnership shall release the assignor from its liabilities to the Partnership, including but not limited to Sections __ and __; provided that if the assignee becomes a Limited Partner as provided in this Section __, the assignor, with the consent of the General Partner, which consent may be granted or denied in the sole discretion of the General Partner, may thereupon so be released (in the case of a partial assignment, to the extent of such assignment).”

B. Other Issues of Particular Interest to Unincorporated Business Organizations
Include:

1. How should UCC Article 8 apply to interests in a LLC, LP and LLP?
2. When are LLC interests and LLP interests treated as “securities” for purposes of state blue sky (securities) laws?
3. What rights may be exercised by the transfer of a bankrupt member of a LLC?
4. Do investments in low-profit limited liability companies (L3Cs) by private foundations necessarily constitute “program related investments”?

⁹⁰ Under §§ 15907.01 of the California Uniform LPA, an assignee is entitled only to its share of distributions attributable to the “transferable interest.”

APPENDIX A

TO BE PUBLISHED IN THE OFFICIAL REPORTS

OFFICE OF THE ATTORNEY GENERAL
State of California

BILL LOCKYER
Attorney General

OPINION	:	No. 04-103
	:	
of	:	July 23, 2004
	:	
BILL LOCKYER	:	
Attorney General	:	
	:	
GREGORY L. GONOT	:	
Deputy Attorney General	:	

THE HONORABLE KEVIN SHELLEY, SECRETARY OF STATE, has requested an opinion on the following question:

May a business that provides services requiring a license, certification, or registration pursuant to the Business and Professions Code conduct its activities as a limited liability company?

CONCLUSION

A business that provides services requiring a license, certification, or registration pursuant to the Business and Professions Code may conduct its activities as a limited liability company if the services rendered require only a nonprofessional, occupational license.

ANALYSIS

The Legislature has enacted a comprehensive statutory scheme, the Beverly-Killea Limited Liability Company Act (Corp. Code, §§ 17000-17655; “LLC Act”) to govern the formation and operation of a limited liability company (“LLC”). In *PacLink Communications Internat., Inc. v. Superior Court* (2001) 90 Cal.App.4th 958, 963, the court quoted from 9 Witkin, Summary of California Law (2001 Supp.) section 43A, page 346, in describing the characteristics of a LLC:

“ ‘A limited liability company is a hybrid business entity formed under the Corporations Code and consisting of at least two ‘members’ [citation] who own membership interests [citation]. The company has a legal existence separate from its members. Its form provides members with limited liability to the same extent enjoyed by corporate shareholders [citation], but permits the members to actively participate in the management and control of the company [citation].’ ”²

While treated like a partnership for income tax purposes, a LLC allows its owners to conduct their business without having personal liability for the obligations of the enterprise. (See § 17101; *Abraham & Sons Enterprises v. Equilon Enterprises* (9th Cir. 2002) 292 F.3d 958, 962; Forming and Operating Cal. Limited Liability Companies (Cont. Ed. Bar 1995) § 1.2, pp. 2-3.) In order to form a LLC, an operating agreement must be entered into by the members and articles of organization must be executed and filed with the Secretary of State. (§ 17050.)

We are asked whether a business that provides services requiring a license, certification, or registration pursuant to the Business and Professions Code may conduct its activities as a LLC. We conclude that it may do so if the services rendered require only a nonprofessional, occupational license.

Section 17002 generally authorizes a LLC to engage in “any lawful business activity”:

“Subject to any limitations contained in the articles of organization and to compliance with any other applicable laws, a limited liability company may engage in any lawful business activity, except the banking business, the

¹ All references hereafter to the Corporations Code are by section number only.

² A limited liability company may now consist of one or more members (§ 17050(a), (b))

business of issuing policies of insurance and assuming insurance risks, or the trust company business.”

One exception to this general authorization, and the statute critical to our analysis, is section 17375, which states that a LLC has no authority to perform certain “professional services”:

“Nothing in this title shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 and in Section 13401.3, in this state.”

“Section 13401 and . . . Section 13401.3,” referred to in section 17375, are contained in the Moscone-Knox Professional Corporation Act (§§ 13400-13410; “PC Act”). Subdivision (a) of section 13401 provides:

“ ‘Professional services’ means any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Business and Professions Code, the Chiropractic Act, or the Osteopathic Act.”

Section 13401.3 states:

“As used in this part, ‘professional services’ also means any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Yacht and Ship Brokers Act (Article 2 (commencing with Section 700) of Chapter 5 of Division 3 of the Harbors and Navigation Code).”

Accordingly, a LLC may conduct certain businesses subject “to compliance with any other applicable laws” (§ 17002) but in any event has no authority to perform “professional services” (§ 17375) as defined in two statutes (§§ 13401, 13401.3) found in the PC Act.

How are these statutes to be interpreted and applied with respect to services requiring a license, certification, or registration pursuant to the Business and Professions Code? Over 60 occupational activities require such a license, certification, or registration, including barbers, locksmiths, private detectives, alarm companies, structural pest control operators, electronic and appliance repair shops, and automotive repair dealers. (See, e.g., Bus. & Prof Code, §§ 6980.10, 7065, 7317, 7520, 7592, 8560, 9840, 9884.)

In analyzing the terms of the LLC Act, including its reference to the PC Act, we may apply well recognized principles of statutory construction. “Our role in construing

a statute is to ascertain the Legislature’s intent so as to effectuate the purpose of the law. [Citation]” (*Hunt v. Superior Court* (1999) 21 Cal.4th 984, 1000.) “ ‘In determining intent, we look first to the words of the statute, giving the language its usual, ordinary meaning.’ “ (*Curie v. Superior Court* (2001) 24 Cal.4th 1057, 1063.) “ ‘The words of the statute must be construed in context, keeping in mind the statutory purpose, and statutes or statutory sections relating to the same subject must be harmonized, both internally and with each other, to the extent possible.’ “ (*Walnut Creek Manor v. Fair Employment & Housing Corn.* (1991) 54 Cal.3d 245, 268.)

We must determine the scope of “professional services” as that term is used in sections 13401, 13401.3, and 17375. “[S]tandard dictionaries . . . generally define ‘profession’ as ‘a calling requiring specialized knowledge and often long and intensive academic preparation.’ “ (*Hollingsworth v. Commercial Union Ins. Co.* (1989) 208 Cal.App.3d 800, 806.) Thus, the adjective “professional” is ordinarily defined as “engaged in one of the learned professions or in an occupation requiring a high level of training and proficiency.” (Webster’s 3d New Internat. Dict. (2002), p. 1811.) Similarly, a “professional” is “a person who belongs to a learned profession or whose occupation requires a high level of training and proficiency.” (Black’s Law Dict. (7th ed. 1999), p. 1226.)

In *Mann v. Department of Motor Vehicles* (1999) 76 Cal.App.4th 312, the court concluded that the services performed pursuant to a vehicle salesperson license issued under the Vehicle Code were not “professional services,” but rather were “nonprofessional, occupational” services. The court analyzed the differences between the two as follows:

“ . . . [C]ourts have drawn a clear distinction between professional licenses, such as veterinarians or psychologists, and nonprofessional occupational licenses. In *San Benito Foods v. Veneman* (1996) 50 Cal.App.4th 1889,1894..., this court held that the preponderance of the evidence standard should be used in administrative proceedings to suspend or revoke a food processor’s license. The court noted that a food processor’s license could be obtained without meeting any educational or skill requirements. The only specific requirements for obtaining such a license were that the applicant show ‘ ‘character, responsibility, and good faith’ ‘ and a sound financial status. [Citation.] In contrast, in order to obtain a professional license, an applicant must ordinarily satisfy extensive educational and training requirements and pass a rigorous state-administered examination. [Citation.]

“A vehicle salesperson’s license is a nonprofessional license. The

license carries no educational, training or testing prerequisites. [Citation.] All of the application criteria concern historical evidence of the applicant’s ‘character, honesty, integrity, and reputation,’ and information regarding prior court judgments and disciplinary actions. [Citation.]” (*Id.* at pp. 318-319.)

Following the reasoning of *Mann*, we find that some services that require a license, certification, or registration pursuant to the Business and Professions Code are “professional services” and others are “nonprofessional services.” To determine whether a particular service is one or the other requires an examination of the educational, training, and testing prerequisites.’

Returning to the language of section 17375, we note that a LLC is not permitted “to render professional services.” A LLC would be permitted to perform “nonprofessional services” without violating this statute. As for section 17375’s reference to “subdivision (a) of Section 13401 and . . . Section 13401.3,” here again these two statutes refer to “professional services” that are performed “pursuant to a license, certification, or registration” Consequently, “nonprofessional services” that require a license, certification, or registration pursuant to the Business and Professions Code would not be covered by the definitions contained in sections 13401 or 13401.3, thus allowing a LLC to perform “nonprofessional services” under the terms of these two statutes.

In so construing the language of sections 13401, 13401.3, and 17375, we harmonize the provisions of the LLC Act and the PC Act. The one refers to the other, and we read the two statutory schemes as a whole. While professional services may not be performed by a LLC, they may be performed by a professional corporation formed under the PC Act. (§§ 13402, 13404.) For example, while attorneys are barred from forming a LLC under the terms of section 17375, they may form a law corporation under the PC Act as authorized by the State Bar Act (see Bus. & Prof Code, §§ 6160-6172). Such other professionals as doctors, dentists, chiropractors, speech pathologists and audiologists, physical therapists, nurses, psychologists, optometrists, pharmacists, veterinarians, marriage and family counselors, clinical social workers, accountants, architects, and shorthand reporters may form professional corporations under the PC Act. Thus, the authorization contained in the PC Act for the rendering of “professional services” in corporate form

³ Applying the *Mann* test to each licensed activity specified in the Business and Professions Code is beyond the scope of this opinion.

confirms our construction of the LLC Act.⁴

We conclude that a business that provides services requiring a license, certification, or registration pursuant to the Business and Professions Code may conduct its activities as a LLC if the services rendered require only a nonprofessional, occupational license.

* * * * *

⁴ We recognize that for some purposes, the term “professional services” has been broadly construed. (See, e.g., *Amex Assurance Co. v. Allstate Ins. Co.* (2003) 112 Cal.App.4th 1246, 1252 [for purposes of a homeowner’s insurance policy, “the word ‘professional’ is no longer limited to the ‘learned professions,’ but has a broader scope that includes skilled services such as plumbing”]; *Hollingsworth v. Commercial Union Ins. Co.*, *supra*, 208 Cal.App.3d at p. 806 [for purposes of a merchant insurance policy, “ ‘professional’ encompasses a broad range of activities beyond those traditionally considered ‘professions,’ such as medicine, law, or engineering”].) Here, we are construing the term “professional services” only for purposes of the LLC Act and its further reference to the PC Act.