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LIMITED LIABILITY COMPANIES

(First of Three Parts)

— by **Neil E. Harl***

Nearly one-half of the states have enacted legislation creating a unique organizational concept, the Limited Liability Company or LLC.[1] The first statute was enacted in Wyoming in 1977[2] but most of the enactments have occurred since 1988. Although the statutes bear certain similarities, there has yet to be developed a uniform or model limited liability company act.

Basic features. An LLC is a hybrid type entity, resembling a corporation with respect to member liability (limited liability for all of its members).[3] If properly structured, an LLC is treated as a partnership for federal income tax purposes.[4]

Limitations on activity. In general, LLCs may carry on any type of business except for those expressly prohibited in the state LLC legislation (such as banking, insurance and professional services).[5] The Kansas[6] and Utah[7] acts specifically authorize an LLC to function in any capacity open to a professional corporation.

Iowa does not permit LLCs to own or lease agricultural land, directly or indirectly:

> "A limited liability company shall not, either directly or indirectly, hold or acquire or otherwise obtain, lease, or have a legal or beneficial interest in any agricultural land in this state. A limited liability company shall not be a shareholder in a corporation, a limited partner in a limited partnership, or beneficiary of a trust which holds or leases any agricultural land in this state...."[8]

An LLC is formed by filing brief articles of organization with a state agency, usually the Secretary of State.[9] In some states, the maximum term of organization is limited.[10]

One important feature, which distinguishes LLCs from S corporations, is no limit is imposed on the number of members in an LLC. Moreover, any kind of entity can be a member.

Management. The legislation authorizing LLCs permits the owners, referred to as members, to define how the LLC is to be operated and the rights of the members. Unless the articles of organization or an operating agreement provides for management by a manager or managers, the management of an LLC is vested in its members.

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The members of an LLC may enter into an operating agreement to establish or regulate the affairs of the LLC. The operating agreement may contain any provisions not inconsistent with the enabling legislation or the articles of organization. In the absence of a clear specification in the governing documents, several "default" provisions apply. Unless otherwise provided —

- The members of an LLC are authorized to vote in proportion to their capital contributions to the LLC, as adjusted to reflect contributions and withdrawals.
- A unanimous vote is required for major decisions such as dissolution, sale of assets or merger.
- Profits and losses are allocated on the basis of the respective capital contributions.
- Distributions are made on the basis of the members' respective contributions.

Doing business in other states. It is generally believed that states with legislation authorizing LLCs would respect the concept for LLCs organized in other states. The greater concern is the treatment of LLCs by states that have not enacted legislation providing for LLCs. In that event, the foreign state may treat the LLC as a general partnership with unlimited liability.

Dissolution. State law of the states authorizing LLCs generally provides that an LLC is dissolved upon the occurrence of the earliest of several events —

- The end of the fixed duration set in the articles of organization for the entity.
- The unanimous consent of all of the members.
- The death, withdrawal, expulsion, bankruptcy or dissolution of a member unless the business is continued by unanimous consent of all of the remaining members, or
- The entry of a decree of judicial dissolution.[11]

FOOTNOTES

1 Ariz. ; Colo. Rev. Stat. §§ 7-80-101 *et seq*.; Del. Code tit. 6, § 18-101 *et seq*.; Fla. Stat. § 608.401 *et seq*.; Ill. Corp. Stat. ch. 805, § 180/1-1 *et seq*.; Iowa Code § 490A.100 *et seq*.; Kan. Stat. § 17-7601 *et seq*.; La. Rev. Stat. § 12:1301 *et seq*.; Md. Code § 4A-101 *et seq*.; Minn. Stat. § 322B.01 *et seq*.; Nev. Rev. Stat. § 86.011 *et seq*.; Okla. Stat. tit. 18, § 2000 *et seq*.; R.I. Stat. § 7-16-1 *et seq*.; Tex. Rev. Civ. Stat. art. 1528n; Utah Code § 48-2b-101 *et seq*.; Va. Code § 13.1-1000 *et seq*.; W. Va. Code § 31-1A-1 *et seq*.; Wyo. Stat. §§ 17-15-101 through 17-15-136 (enacted in 1977). See generally 8 Harl, **Agricultural Law** § 61.03 (1993).

2 *See* n. 1 *supra*.

3 *E.g.*, Iowa Code § 490A.601; Nev. Rev. Stat. Ann. § 86.371.

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[4] *See, e.g.*, Rev. Rul. 93-30, I.R.B. 1993-16, 4. See also Ltr. Rul. 8106082, Nov. 18, 1980 (ruling on Wyoming enactment). But see Rev. Rul. 93-38, I.R.B. 1993-21, 4 (limited liability company (LLC) formed under Del. Code tit. 6, §§ 18-101 *et seq.* may be taxed as corporation or partnership because Act allows LLC agreement to provide for centralized management and continuation of company without consent of members after transfer of member's interest).

[5] *See* Va. Code Ann. § 13.1-1008.

[6] Kan. Stat. Ann. §§ 17-7603(a), 17-7604(q).

[7] Utah Code Ann. § 48-2b-104.

[8] Iowa Code § 9H.3A.

[9] *E.g.*, Iowa Code §§ 490A.128, 490A.301.

[10] *E.g.*, Wyo. Stat. § 17-15-107(a)(ii).

[11] *E.g.*, Iowa Code § 490A.1301.

INCOME TAX TREATMENT OF HEDGING

The United States Tax Court has decided a case of substantial importance to the tax treatment of commodity hedges. The issue of the proper handling of hedge transaction gains and losses has been a matter of concern since issuance of a letter by Stuart L. Brown, Associate Chief Counsel (Domestic), IRS, to Henry Bahn, USDA, regarding the Options Pilot Program on January 27, 1993. (See pp. 32 and 80 *supra*.)

In the Tax Court case, the Federal National Mortgage Ass'n had hedged debentures and mortgages with short sales of Treasury securities. Losses were deducted as ordinary losses. I.R.S. objected, citing *Arkansas Best Corp. v. Comm'r, 485 U.S. 212 (1988)*, for the proposition that the gains and losses were properly capital transactions.

The Tax Court held that the FNMA transactions were hedges and that disposition of the hedges resulted in ordinary gains and losses.

The court noted that the transactions were meant to offset the risk of change in interest rates and were, therefore, true hedges. In response to the argument that FNMA had not offset all of its risk, an argument sometimes made with commodity futures transactions, the court said,

> "A taxpayer is not required to negate its entire risk, nor must it hedge every transaction in order to lock in a particular return, since hedges by their very nature are meant to avoid risk of loss (similar to insurance), but not necessarily all risk to which a taxpayer is exposed."

In deciding that the losses on the hedges were ordinary losses rather than capital losses, the court concluded that short positions as well as long positions could reduce price risk and that it was not necessary for ordinary gain and loss treatment for the hedge to be in the same asset that the taxpayers owns or intends to acquire. The court explained that for the hedging position to be eligible for ordinary gain or loss treatment, the hedging transactions must have been integrally related to the purchasing and holding of the assets hedged. In the FNMA case, the court concluded that the hedges bore a close enough relationship to FNMA's mortgages to be excluded from the definition of a capital asset.

Another case is still pending before the Court of Federal Claims, *Cather v. U.S.*, which involves hedging of beef cattle and feed grains, including the use of various options strategies (puts and calls). The FNMA case provides a good deal of assurance that commodity hedges, including short sales, will produce ordinary gain or loss treatment. **Federal Nat'l Mortgage Ass'n, 100 T.C. No. 36 (1993)**.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL

ABSOLUTE PRIORITY RULE. The debtors owned a farm under a sole proprietorship and in their Chapter 11 plan proposed to contribute their labor and exempt property to the farm business to satisfy the absolute priority rule. The debtors' attorney also agreed to be paid out of future farm earnings instead of estate property. The debtors claimed that because the farm business had little or no "going concern" value, the debtors did not retain any interest of value. The court rejected this argument, noting that the U.S. Supreme Court in *In re Ahlers, 485 U.S. 197 (1988),* held that the retained control over the business and possible future earnings from the business were not sufficient retained interests to invoke the absolute priority rule. The court held that there was no new value exception to the absolute priority rule, but even under such an exception, the debtors' contribution must be necessary for the reorganization and must be substantial and exceed the value of the debtors' retained interests in the business. The debtors were held not to have met the burden of showing their entitlement to the exception. **Unruh v. Rushville State Bank, 987 F.2d 1506 (10th Cir. 1993), *aff'g*, 135 B.R. 410 (D. Kan. 1991), *aff'g*, 108 B.R. 284 (Bankr. D. Kan. 1989)**.

EXEMPTIONS-*ALM* § 13.03[4].*

AVOIDABLE LIENS. The debtor sought to avoid a judgment lien to the extent the lien impaired the debtor's homestead exemption. The judgment was entered to enforce an otherwise unavoidable student loan. The court held that the student loan judgment lien was avoidable to the extent it impaired the homestead exemption. ***In re* Evaul, 152 B.R. 31 (Bankr. W.D. N.Y. 1993)**.

HOMESTEAD. The Bankruptcy Court had ruled that the debtor's entire 32 acre residence was exempt as a rural homestead because Tex. Prop. Code § 41.002(c) defined a homestead as rural if it did not receive municipal utilities or fire or police protection. The District Court reversed and remanded, holding that the statute applied only in foreclosure situations and did not overturn Texas common law which established various factors for determining the