Wisconsin's Limited Liability Company: Emerging Issues and Prospects for the Future

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WISCONSIN'S LIMITED LIABILITY COMPANY: EMERGING ISSUES AND PROSPECTS FOR THE FUTURE

I. INTRODUCTION

When forming a business, Wisconsin entrepreneurs can finally have their cake and eat it too. The utensil?—Wisconsin's new Limited Liability Company Act,1 which went into effect on January 1, 1994. Wisconsin joins thirty-seven other states, including all of its neighboring states, in enacting such legislation.2 A limited liability company ("LLC") is a business entity whereby its members cannot only actively participate in the business and benefit from the traditional partnership tax treatment, but also can enjoy the limited liability of traditional corporate shareholders. As this comment will demonstrate, until the advent of the LLC,


achieving both beneficial tax treatment and limited liability in a single business entity was, while possible, somewhat difficult.\textsuperscript{3}

This Comment will analyze the LLC as an alternative to other business formations, track its development and complexities, and focus on Wisconsin's new act as compared to other LLC statutes, with emphasis on the Illinois\textsuperscript{4} and Minnesota\textsuperscript{5} statutes. Part II of this Comment will provide a general overview of the LLC and outline the development of partnership tax treatment, one of the LLC's indispensable features. Part III will compare the LLC to the limited partnership and the S-corporation, two other types of business forms whose members or shareholders enjoy limited liability and are taxed as partnerships—commonly called "pass-through entities" ("PTEs"). Part IV addresses some potentially troublesome areas and emerging issues surrounding the new entity such as interstate treatment and security issues associated with the LLC ownership interest, and how newly drafted statutes in states such as Wisconsin, Illinois, and Minnesota deal with these issues.

II. THE LIMITED LIABILITY COMPANY

A. General Overview

Fundamentally, the LLC adopts the most favorable characteristics from both the corporate and partnership forms, while at the same time eliminating the detrimental aspects of each.

When forming any business organization, an interplay exists between (1) the amount of control that each participant has over the operations of the business, (2) the potential liability of each participant resulting from an exercise of such control, (3) the degree of flexibility that each participant has in manipulating the structure of their particular organization, and (4) the tax treatment under both federal and state law. For example, one possible way to structure a business entity is the general partnership. All members of a general partnership have control over all of the organization's activities, but at the same time all partners are jointly and severally liable for all obligations of the partnership.\textsuperscript{6} At the other end of the business organization spectrum is the corporation. With this entity, the owners or shareholders are not personally liable for the

\textsuperscript{3} See infra note 105 and accompanying text.
\textsuperscript{5} MINN. STAT. ANN. § 322B (West 1993).
\textsuperscript{6} UNIF. PARTNERSHIP ACT § 15 (1914)[hereinafter UPA].
debts or obligations of the corporate entity, but they sacrifice the right to participate in the control of the corporation.

Other associations have developed over time at various points within this business organization spectrum. However, no business entity has been able to merge the two extremes. Enter the LLC. As the name limited liability company implies, its members have "limited liability" like a corporation. In other words, only the capital invested in the LLC is at risk, just as if the member was buying shares of stock. The members also have a right to participate in management and control of the LLC, receive the benefit of pass-through taxation like the traditional partnership, and have flexibility in organizing the entity that has not yet been available in other types of organizations. Additionally, there is no limit on the number of members or the types of members with the LLC, making it easier to acquire large amounts of capital and to expand into other states and countries. Furthermore, there is no need for the LLC to have a general partner whose liability is not limited to the initial investment, because all of the members of an LLC can participate in management.

7. For example, a limited partnership has limited liability, flexibility in manipulating the structure of the business, and partnership tax treatment; however, limited partners have no control of the general management of the partnership. See UNIF. LIMITED PARTNERSHIP ACT § 7 (1916) [hereinafter ULPA]; REVISED UNIF. LIMITED PARTNERSHIP ACT § 303 (1985) [hereinafter RULPA]. See infra Part III.

8. All LLC statutes contain a section that specifically limits each member's liability. This is not to say, however, that the members are not responsible for their own negligence or other conduct. For example, Wisconsin's statute states:

The debts, obligations and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company. . . . [A] member or manager of a limited liability company is not personally liable for any debt, obligation or liability of the limited liability company, except that a member or manager may become personally liable by his or her acts or conduct other than as a member or manager.


9. See discussion infra part II.B.

10. See discussion of other pass-through entities infra part III.

11. For example, Wisconsin's LLC Act provides that "[o]ne or more persons may organize a limited liability company . . . ." Wis. Stat. § 183.0201 (1993-94). "Person" is defined as "an individual, a general partnership, a limited partnership, a domestic or foreign limited liability company, a trust, an estate, an association, a corporation or any other legal or commercial entity." Wis. Stat. § 183.0102(18)(1993-94).


13. Another mechanism that approximates the advantages of the LLC is the limited partnership with a thinly capitalized corporate general partner. Although this achieves the desired
One of the few drawbacks of the LLC is that to some extent the statutes restrict the transferability of the members' ownership interests. However, as the following sections will demonstrate, this drawback is becoming more favorable from the LLC member's standpoint as the entity gains wider acceptance.

B. Tax Treatment of the Limited Liability Company: Partnership or Corporation?

A closely-held corporation, where the directors and officers are also the owners of the company, is disadvantaged because it is taxed as a corporation. Essentially, the owners or directors are taxed twice—once when the corporation is taxed as a separate entity, and again when the profits are distributed in the form of dividends that are taxed as income at the individual level. On the other hand, a group of individuals forming a partnership maintain their individuality at tax time. Thus, the partnership is an association of individuals and not taxed as a separate entity. The individual partner pays taxes on his or her respective profits. Given this, it is easy to see why owners or investors usually prefer partnership tax treatment over corporate tax treatment. The tax-treatment decision, however, is not an easy one. In most circumstances the decision to be taxed as a partnership is very entity-specific and complex. When choosing to organize as a partnership or a corporation, each member must compare his or her individual tax bracket with the marginal rates of tax on corporations, and then consider the goals and desired structure of their organization. Traditional partnership tax rules have not been ap-

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result, the thinly capitalized corporate general partner can simply declare bankruptcy if held "personally" liable for debts or obligations. The downside to this formation, however, is that it is more difficult to organize and control. Richard Johnson, Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387, 403-04 (1983). One state has even refused to recognize the corporate general partner if used for the purpose of avoiding personal liability. *See* Delaney v. Fidelity Lease Ltd., 526 S.W.2d 543 (Tex. 1975).

14. Restricting the transferability, however, is by design and is consistent with the ULPA and the RULPA §§ 7 and 303, respectively. Limited transferability of interests is one of features that a LLC must possess in order to achieve federal partnership taxation treatment. By statutorily restricting transferability, one of the criteria used to determine partnership taxation is assured. *See* discussion infra part II.B.4.


16. By definition, closely held corporations are owned by the same people who direct and manage them.

17. With the signing of the Omnibus Budget Reconciliation Act of 1993, individual tax rates exceed corporate tax rates for the first time since 1986. The effect on LLCs is difficult to predict, and individuals must take into account the new provisions when deciding what entity to form. For an excellent discussion of some of these new provisions *see* Mary L. Harmon,
plied to LLCs in the past. Only time will tell how the Internal Revenue Service ("IRS") will treat some of these issues in the LLC arena, such as: permissible methods of accounting allocation of liabilities to partners, passive loss limitations, audit proceedings, and self-employment taxes.

Even after a group of investors decide that they want pass-through taxation to apply to their organization, it is not an automatic process. The newly formed business must be carefully structured so that it satisfies the legal requirements of an entity entitled to pass-through taxation. In order to qualify, the entity must not have more corporation-like characteristics than partnership-like characteristics. The United States Supreme Court originally laid out these characteristics in the landmark case of *Morrissey v. Commissioner*. They are now used by the IRS to determine if an entity will be taxed at the individual level only, as in a partnership tax scheme. *Morrissey* listed six characteristics of a corporation that distinguish it from other types of business associations: (1) associates, as opposed to an individual undertaking, (2) an objective to carry on a business and divide the gains therefrom, (3) centralized management, (4) continuity of life, (5) transferability of ownership interests, and (6) liability for corporate debts that is limited to corporate property. Because the first two characteristics are common to both partnerships and corporations, they are not used in the determination of whether a business association is taxed as a corporation or a partnership.

Therefore, we are left with four characteristics that distinguish a partnership from a corporation. Because the entity must not have more corporate characteristics than partnership characteristics, it must lack at least two of the four remaining characteristics to qualify for pass-through

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19. See infra note 65 and accompanying text.
taxation. In the context of the LLC, the importance of these four characteristics should not be underestimated. As such, each characteristic will be dealt with in turn to generally outline their complexities, subtleties, and evolution since Morrissey.

1. Continuity of Life

Continuity of life is simply when an organization continues to exist if something happens to a member of the organization. If the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member causes the dissolution of the organization, that organization lacks the corporate characteristic of continuity of life. The significance of this definition is best shown by example. For instance, assume that a shareholder of a corporation dies. This death will have no effect on the other shareholders or the corporation if the corporation has the continuity of life characteristic. The corporation will continue to exist as if nothing changed. In a general partnership, however, the death of a partner may cause a dissolution because the relationship between the members changes. The deceased member's proportional amount of control and share of the profits might be reallocated and distributed, respectively, among the remaining general partners; thus changing the identity of the organization. Or, the deceased member's control and share of profits might be inherited by a third party. In either case, the relationship among the remaining partners changes. The organization does not simply continue as if nothing happened.

Obviously, a dissolution event that terminates the entity can be troubling, especially when the remaining members of a successful organization want to continue operations despite the dissolution event. Thus, in the LLC statutes, as in the limited partnership arena, legislators addressed this problem by providing that the remaining members may elect to continue the LLC. The issue then becomes: How far can the stat-

28. Because a detailed analysis is beyond the scope of this comment, discussion is limited to broad issues. For a more detailed analysis see Frost, supra note 27.

29. The Treasury Regulations define dissolution as "an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law." Treas. Reg. § 301.7701-2(b)(2) (1967).


31. See, e.g., Wis. Stat. § 183.0901 (1993-94). Some of the older statutes are more rigid and do not permit flexibility in structuring a LLC. These statutes are commonly known as "bulletproof," because they ensure that the LLC will meet the continuity of life and other Morrissey characteristics. Originally, the Internal Revenue Service ["IRS"] revenue rulings recognized "LLCs as lacking continuity of life only under bulletproof statutes." Limited Lia-
utes go in allowing this flexibility before an LLC is deemed to possess the corporate characteristic of continuity of life?

If statutes and operating agreements permit the continuation of the LLC, they will most likely be deemed to have continuity of life by the IRS. To illustrate this point, assume a forty-member LLC operating agreement provides that the entity can continue after a dissolution event with a single vote. The likelihood that one of the members would make such a vote is high enough that, for practical purposes, the LLC's life is identical to a corporation's life. Originally, there was concern that only the LLCs that made it difficult to continue operations would lack continuity of life. For example, the Treasury Regulations state that requiring unanimous consent to continue after a dissolution event is burdensome enough so as not to have the appearance of a corporation. However, the Treasury Regulations were amended to provide that a partnership will not be deemed to have continuity of life as a result of a provision in its partnership agreement that allows the partnership to be reconstituted by the agreement of the remaining general partners or a majority interest of the remaining partners after the occurrence of any event of dissolution. Additionally, the IRS appears to treat LLCs along the same lines as the amendment for partnerships. The IRS privately ruled that an LLC requiring a less-than-unanimous vote to continue after a dissolution event will still lack continuity of life.

2. Centralized Management

An organization has the corporate characteristic of centralized management "if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed." The managers need not be members and must have the sole authority to make decisions. Thus, in organizations

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35. See, e.g., Priv. Ltr. Ruls. 93-08-027 (Nov. 27, 1992); 93-21-047 (Feb. 25, 1993); 93-25-039 (Mar. 26, 1993); 93-39-032 (July 6, 1993). In these rulings, LLCs still lacked continuity of life where only a majority vote, not unanimous consent, was required to continue.
like limited partnerships, where a general partner makes the decisions, or corporations, where directors make the decisions, there would be centralized management. It is generally assumed that centralized management exists in an LLC where a manager is appointed,\(^{39}\) but an LLC will lack centralized management when the members, by virtue of being members, manage the LLC.\(^{40}\) For this reason, an LLC will lack centralized management under most statutes unless managers are appointed.\(^{41}\)

In some situations, however, if the members themselves are designated as managers, the LLC will possess centralized management, even if all of the members are managers. For example, Revenue Ruling 93-6\(^ {42} \) involved a Colorado LLC with five members who were elected as managers. Notably, however, the Colorado statute\(^ {43} \) does not vest management powers in the members themselves, unlike the Wisconsin and Illinois statutes.\(^ {44} \) Furthermore, the Colorado statute requires that managers be elected, regardless of whether or not they are members.\(^ {45} \) The IRS’s highly semantical reasoning illustrates reluctance to allow the LLC form to lack centralized management. The ruling held that the company had centralized management, stating that the “authority to make management decisions rests solely with the five members in their capacity as managers rather than as members.”\(^ {46} \) This is strong evidence that the IRS will never treat manager-managed LLCs as lacking centralized management, even if all members are managers. However, the distinct possi-
bility remains that the IRS may someday rule in favor of treating manager-managed LLCs as lacking centralized management on agency principles similar to limited partnerships.  

3. Limited Liability

An association has the corporate characteristic of limited liability "if under local law there is no member who is personally liable for the debts of or claims against the organization." There is no limited liability if a creditor of an organization may seek personal payment from an individual member of the association to the extent that the association cannot meet the creditor’s claim. By its name, an LLC indicates that there will be “limited liability.” Unlike the limited partnership, LLC members do not lose their limited liability by participating in LLC management. Therefore, creditors are only protected by the rules regarding disclosure, distributions, and dissolution, and should not depend on the members’ personal liability.

Despite statutory provisions limiting liability, an LLC member may still be held personally liable in certain circumstances. One area of uncertainty is whether courts will honor an LLC member’s limited liability when the LLC conducts interstate transactions. Also, an LLC member may be liable if courts use an analogous “piercing the corporate veil” principle.

Because of the economic inefficiency that limited liability can cause in areas such as financial institution loans and credit extensions, members may not want limited liability for specific transactions. To alleviate this problem, statutes may allow flexibility by permitting LLC members to modify their liability through the operating agreement.

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47. Harmon, supra note 17, at IV.B.1. See also Treas. Reg. § 301.7701-2(c)(4) (1967).
49. Id.
50. However, “a member may not be able to limit the member’s liability for his or her own acts (e.g., malpractice). In addition, certain states may not allow a member to limit liability for a co-member’s malpractice.” Harmon, supra note 17, at IV.C.2.
51. Keatinge et al., supra note 12, at 385.
52. Id.
53. See infra part IV.B.
54. Wis. Stat. § 183.0304(2) (1993-94) states that “nothing in this chapter shall preclude a court from ignoring the limited liability company entity under principles of law similar to those applicable to business corporations and shareholders in this state...” (emphasis added). For Wisconsin’s theory of “piercing the corporate veil,” see Consumer’s Co-op v. Olsen, 142 Wis. 2d 465, 419 N.W.2d 211 (1988). See also Keatinge et al., supra note 12, 445-46.
extend funds without such a guarantee. Therefore, although one of the primary reasons for choosing the LLC is to limit liability, it is possible to modify the liability arrangements. However, this flexibility brings up the question of how many times the members may make modifications before the LLC, as an entity, no longer has limited liability.\(^5\) Notwithstanding this observation, if the members agree to be personally liable for the entity's debt and the IRS rules that limited liability is lacking,\(^5\) partnership status for tax purposes would be easier to achieve because only one of the other three corporate characteristics would have to be lacking to achieve partnership tax treatment.

4. Free Transferability of Interests

A business association has the corporate characteristic of free transferability of interests if those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute a non-member for themselves in the same organization.\(^5\) The member must be able to confer upon the non-member all of the attributes of the member's interests in the entity. Most statutes only allow the transfer of the member's economic or financial rights, and do not allow the assignee to participate in the other rights of membership, such as the right to participate in management or the right to vote. Economic or financial rights include the rights to receive distributions from the LLC and to share in the LLC's profits and losses. However, statutes that limit the transferability of interests to economic or financial rights allow the transferee to participate in management if the other (non-transferring) members unanimously consent to such participation. The IRS ruled that this unanimous consent exception does not make the interests freely transferable.\(^6\)

Proponents of LLCs, again pressing for more flexibility, argue that an LLC allowing a member to transfer all rights of membership when a majority of the non-transferring members consent should not be deemed to have free transferability of interests.\(^6\) In other words, receiving the votes of the majority of the non-transferring members does not make

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56. The IRS is considering whether an assumption of liability would cause the entity to lack limited liability. Harmon, supra note 12, at IV.C.1.

57. Id.


60. The argument is primarily based on Rev. Rul. 88-79, 1988-2 C.B. 361, which held that a majority consent agreement still lacked free transferability. This ruling, however, was on a business trust, not a LLC.
transferring easy enough to be termed "freely transferable." In the LLC arena, the IRS has issued private letter rulings, but no published rulings, allowing an LLC member to completely transfer his or her interest when a majority of the members consent. As this area develops, statutes will adopt flexible standards whereby the unanimous consent rule may be modified in the articles of organization or similar governing instrument.

As stated above, the interplay between control, potential liability, flexibility, and tax treatment is manifested with every new IRS ruling or change in Treasury Regulation. While complicated at first glance, it is, however, fairly easy for entrepreneurs to use the LLC as a vehicle for ensuring both hands-on control of their business and limited liability in the event of a mishap, while at the same time achieving partnership tax treatment. In the next section, we will see why and how the LLC simplifies this once complicated process.

III. Other Pass-Through Entities and the LLC

The subchapter S corporation (commonly known as an "S-Corp") and the limited partnership both have three of the four characteristics that LLCs offer—flexibility, pass-through tax treatment, limited liability, and owner control. This section takes a closer look at both of these forms of business organizations and how they fall short of the LLC.

A. The Limited Partnership

Although limited partners possess limited liability, benefit from partnership tax treatment, and retain flexibility in structuring the partnership agreement, some serious drawbacks exist as to the limited partnership form, making the LLC a better choice for business formation. First, limited partners cannot participate in the management or control without jeopardizing their limited liability. However, LLC members are treated as corporate shareholders, and are able to participate in the management of the organization without risking personal liability. Another disadvantage attributable to limited partnerships is that the partners must select a general partner to run the business. The general partner or

63. See ULPA § 7; RULPA § 303.
partners in limited partnerships do not have limited liability, and are therefore personally liable for the debts and obligations of the entity.\textsuperscript{64}

As for tax consequences, limited partners must materially participate in the business to avoid the "passive activity loss" limitations.\textsuperscript{65} However, because any participation in management by a limited partner subjects that partner to personal liability, a limited partner could never qualify for the favorable tax treatment. On the other hand, LLC members can materially participate in the management of the LLC without losing their limited liability characteristic.

**B. The Subchapter S Corporation**

S-Corp shareholders enjoy limited liability, control, and pass through taxation, but sacrifice flexibility. An S-Corporation is limited to no more than thirty-five\textsuperscript{66} United States citizens or resident alien shareholders.\textsuperscript{67} These strict structural requirements can stifle potential expansion opportunities into other states and abroad, which is especially troublesome given the accelerated evolution of the global marketplace. Furthermore, S-Corporations can have only one class of stock\textsuperscript{68} and cannot own eighty percent or more of another corporation.\textsuperscript{69} The former limits the flexibility in financing arrangements, and the latter precludes S-Corporations from forming wholly owned subsidiaries.

On the other hand, none of the above requirements apply to the LLC. An LLC can have an unlimited number of members,\textsuperscript{70} including, but not limited to non-resident aliens, employee stock ownership plans (ESOPs), trusts, and charities. In addition, LLC members can manipulate their ownership interests in order to allocate profits and losses among the members.\textsuperscript{71} Finally, without the eighty percent stock ownership requirement, LLCs can form wholly owned subsidiaries if desired.

Turning to the tax characteristics, the S-Corp lacks some of the partnership tax advantages that LLC members possess.\textsuperscript{72} For example (assuming the LLC achieves pass-through tax treatment), if the LLC has a

\begin{itemize}
\item \textsuperscript{64} ULPA § 9.
\item \textsuperscript{65} I.R.C. § 469 (West 1993).
\item \textsuperscript{66} I.R.C. § 1361(b)(1)(A) (West 1994).
\item \textsuperscript{67} I.R.C. § 1361(b)(1) (West 1994).
\item \textsuperscript{68} I.R.C. § 1361(b)(1)(D) (West 1994).
\item \textsuperscript{69} I.R.C. § 1361(b)(2)(A) (West 1994).
\item \textsuperscript{70} In states like Wisconsin, this is subject to possible securities law intervention. See discussion \textit{infra} part IV.B.
\item \textsuperscript{71} Provided the allocations have "substantial economic effect." See I.R.C. § 704(b) (West 1993).
\item \textsuperscript{72} See generally I.R.C. §§ 1361-1379 (West 1993).
\end{itemize}
section 754 election in effect, when an LLC member sells his interest, the transferee is entitled to increase his or her basis in the LLC's assets if the basis of the LLC interest is greater than the adjusted basis of the proportional share of the LLC's assets when the membership began.73

IV. THE EMERGENCE AND FUTURE OF THE LLC

When the first LLC statutes74 were enacted, entrepreneurs had little interest in them.75 The IRS's position on the federal tax classification of the new entity is the primary reason for this aversion.76 Initially, the IRS wanted automatically to tax any entity as a corporation that provided limited liability to its members or shareholders.77 Oddly enough, not long after this proposal, a private letter ruling was issued holding that a Florida LLC was to be treated as a partnership, subject to reversal upon the adoption of the proposed regulation.78 Although the proposed regulation was eventually withdrawn,79 investors in the states that enacted LLC statutes,80 and legislatures in states without LLC statutes, were intimidated enough to stay away from the new entity. Five years passed. In 1988, the floodgates opened when the IRS ruled that a Wyoming LLC would be treated as a partnership for federal taxation purposes.81 Since then, the IRS issued several similar rulings, including seven in 1993.82 This trend of uniformity by the IRS should continue as the LLC gains nationwide acceptance.

This section looks at some of the emerging issues affecting LLCs, including interstate treatment of state statutes and whether the LLC interest should be treated as a security.

73. I.R.C. § 743(b) (West 1993).
74. Wyoming and Florida were the first two states to adopt LLC legislation. See generally FLA. STAT. ANN §§ 608.401 to 608.471 (West Supp. 1993); Wyo. STAT. §§ 17-15-101 to 17-15-136 (1994).
75. In the year after Florida enacted its LLC statute, only two LLCs formed. Johnson, supra note 13, at 388.
76. Id. at 394.
78. See Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980)(basing its finding on the fact that the LLC at issue lacked the corporate characteristic of continuity of life and free transferability of interests).
80. At this time there were only two, Wyoming and Florida.
A. Pass-Through Taxation

As the IRS's position on partnership taxation treatment evolved, so did the statutes. The earlier\textsuperscript{83} statutes were rigid, or "bulletproof," in that they did not allow the members to modify certain statutory provisions dealing with the partnership tax treatment requirements: continuity of life, free transferability of interests, limited liability, and centralized management. The early statutes ensured that the LLC would definitely be taxed as a partnership by restricting the LLC's structure so as to comply with the requirements given in the Internal Revenue Code and the Treasury Regulations. Nevertheless, as the IRS solidifies its position on LLC tax treatment, states with bulletproof LLC statutes are scrambling to amend the bulletproof provisions, and states enacting new LLC statutes are adopting flexible, non-bulletproof requirements.\textsuperscript{84}

The flexible statutes allow drafters of operating agreements to accommodate their clients' needs by letting them choose which of the two corporate characteristics they want to have and then making sure that the LLC lacks the other two, thus, guaranteeing pass-through taxation treatment.\textsuperscript{85} Furthermore, flexible statutes will not have to be amended if and when the IRS changes its treatment of a particular corporate characteristic. Certainly, it can be argued that flexible statutes not only make it easier to fail the \textit{Morrissey} corporate characteristic tests,\textsuperscript{86} but flexible statutes also increase legal fees arising from additional drafting required to guarantee partnership taxation treatment. While these arguments do have some merit, they are overshadowed by the benefit of putting the members in the driver's seat when structuring their business. Furthermore, because most non-bulletproof statutes provide default provisions ensuring partnership taxation treatment, investors concerned with runaway drafting costs can always sacrifice flexibility and defer to the default rules.

\textsuperscript{83} "Earlier" used in the context of statutory LLCs is quite misleading when one considers the rapid expansion of the LLC entity. Many LLC provisions adopted in 1991 and 1992 are already outdated in light of the recent IRS letter revenue rulings, the promulgation of the Prototype Limited Liability Company Act from the ABA Section of Business Law on Partnerships and Unincorporated Business Organizations, the Uniform Limited Liability Company Act drafted by the National Conference of Commissioners on Uniform State Laws, and the number of states that have recently adopted LLC statutes.

\textsuperscript{84} Minnesota has amended its statute and Wisconsin and Illinois have adopted non-bulletproof statutes.

\textsuperscript{85} See discussion \textit{supra} part II.B.

\textsuperscript{86} See \textit{supra} part II.B.
B. Interstate Commerce

Although the Interstate Commerce Clause allows a business association to conduct business outside of the state where it is organized, "[s]tates are . . . not precluded from exercising reasonable control over foreign corporations transacting business within their state through the use of the police power." For interstate LLC transactions, the doctrines of conflict of laws, choice of law, or both control. Although a detailed analysis of this is beyond the scope of this Comment, three situations exist where choice of law needs to be addressed: (1) where both states have LLC statutes and an LLC organized under one state wishes to do business in the other; (2) where the transacting LLC wants to do business in a state that has adopted a foreign LLC statute; and (3) where an LLC wants to do business in a state with no LLC statute.

The first scenario has been addressed by statute. Generally, LLC statutes explicitly provide that foreign LLCs will be governed under the laws of the state of organization. Wisconsin, Illinois, and Minnesota statutes are no exceptions. The importance of these provisions should not be overlooked. By promulgating rules governing foreign LLCs, states are, in effect, promoting efficient and fair markets. Assuring wary investors that the benefits they enjoy at home will be recognized in other states makes the LLC as an entity more attractive.

In light of the recent explosion of LLC legislation throughout the country, the issues arising under the second and third scenarios are quickly becoming moot. The second scenario arises when a state allows a foreign LLC to conduct business within the state, generally subject to registration requirements. As mentioned above, general conflicts of law principles authorize states to require foreign LLC registration, and

87. Keatinge, supra note 12, at 447 (citing Robert A. Leflar et. al., AMERICAN CONFLICTS LAW § 256, at 709 (4th ed. 1986)).
88. Id. at 449.
89. Keatinge, supra note 12, at 385.
90. Wisconsin's LLC Act states: "The laws of the state or other jurisdiction under which a foreign limited liability company is organized shall govern its organization and internal affairs and the liability and authority of its managers and members . . . ." WIS. STAT. § 183.1001(1)(1993-94). The Minnesota and Illinois Acts are similar and both mirror the earlier LLC statutes. See MINN. STAT. ANN. § 322B.90 (West Supp. 1993); 1992 ILL. LEGIS. SERV. 2304 § 45-1; COLO. REV. STAT. ANN. § 7-80-901 (West. Supp. 1994). Colorado was the third state to adopt LLC legislation.
91. For a more in-depth discussion of interstate LLC transactions, see Keatinge, supra note 12, at 448-49.
92. See supra, note 89.
all states with LLC legislation have specific sections dealing with foreign LLCs and registration requirements thereof.93

As for the third scenario, where an LLC wants to do business in a state with no LLC statute,94 analysis requires consideration of the second edition of the Restatement of Conflict of Laws section 6(2), common law principles of comity, the Full Faith and Credit Clause, and the Interstate Commerce Clause of the United States Constitution.95 With only three states and the District of Columbia yet to enact or propose LLC legislation, this problem may not exist much longer. Notwithstanding this fact, allowing foreign LLCs to conduct business within these states is not only consistent with the principle of comity and Constitution, it is an economic necessity. With the inevitable widespread use of the LLC, states refusing to recognize the entity will unfairly hamper business within that state. Not only will that state lose the benefit of attracting new business start-ups, but it will also restrict its own businesses to dealing with non-LLC entities exclusively.

93. See, e.g., Wis. STAT. § 183.1002(1)(1993-94)(providing that “[a] foreign limited liability company may not transact business in this state until it obtains a certificate of registration from the secretary of state.”); 1992 Ill. Legis. Serv. 2304 § 45-5 (providing that “[b]efore transacting business in this State, a foreign limited liability company shall be admitted to do so by the Secretary of State.”); Minn. STAT. ANN. § 322B.91 (West Supp. 1993) (providing that “[b]efore transacting business in this state, a foreign limited liability company shall obtain a certificate of authority... [from] the secretary of state.”).

94. One of the major reasons why investors were reluctant to organize as an LLC under the early statutes was the concern that states would not recognize foreign LLCs. Johnson, supra note 13, at 401-02.

95. Keatinge, supra note 12, at 451-52. Minnesota has taken these principles and codified them in its LLC statute:

By enacting this chapter the Minnesota legislature recognizes the limited liability company as an important and constructive form of business organization. The legislature understands that: (1) businesses organized under this chapter will often transact business in other states;

(2) for businesses organized under this chapter to function effectively and for this chapter to be a useful enactment, this chapter must be accorded the same comity and full faith and credit that states typically accord to each other’s corporate laws; and

(3) specifically, it is essential that other states recognize both the legal existence of limited liability companies formed under this chapter and the legal status of all members of these limited liability companies.

The legislature therefore specifically seeks that, subject to any reasonable registration requirements, other states extend to this chapter the same full faith and credit under section 1 of Article IV of the Constitution of the United States, and the same comity, that Minnesota extends to statutes that other states enact to provide for the establishment and operation of business organizations.

C. Should LLC Interests be Treated as Securities?

The Federal Securities Act of 1933,96 which regulates public offerings of securities, defines "security" as "any note, stock, ... certificate of interest or participation in any profit-sharing agreement, ... [or] investment contract." At first glance, interests in LLCs do not appear to be "securities," because generally no evidence of ownership comparable to a stock certificate or similar instrument exists. However, in SEC v. W.J. Howey Co.,97 the Supreme Court defined an investment contract as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ."98 Therefore, whether an LLC interest is treated as a security hinges on whether profits are expected 'from the efforts of the promoter or a third party.' In a very closely held member-managed LLC, in which each member actively participates, the courts probably will hold that an LLC interest does not constitute a security. In a manager-managed LLC, or even a member-managed LLC in which members do not actively participate in management, there is a greater possibility that the federal securities laws will apply.99

Classification of an LLC interest as a security has become a crucial consideration in light of a recent article published in the Wall Street Journal.100 The article exposed a developing problem in states that do not treat LLC interests as securities: fraudulent operators who use the LLC to "package[,] their investment products by setting up an LLC and then selling units in it to the public to avoid state and federal securities laws."101 Wisconsin, however, is not a state with such a problem. The newly enacted legislation provides that an LLC interest will be presumed to be a security whenever the LLC (1) is manager-managed, or (2) has more than thirty-five members after the interest is sold.102 However,

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97. 328 U.S. 293 (1946).
98. Id. at 298-99.
101. Id.
102. Wis. STAT. §§ 183.1303 (1993-94) provides that "[a]n interest may be a security" as defined in Wisconsin's "Blue Sky" Law, chapter 551:

"Security" does not include . . . any interest in a limited liability company organized under ch. 183 if the aggregate number of members of the limited liability company, after the interest is transferred, does not exceed 15 and the right to manage the limited liability company is vested in its members.

. . . .
both the Minnesota and Illinois LLC Acts lack similar provisions. While the Illinois statute is silent on the issue, Minnesota's specifically provides that an LLC interest will not be treated as a security under its "blue sky" laws.\textsuperscript{103} As with any new business entity, unforeseen problems can arise, and the limited liability company is no exception.

Wisconsin appears to be one of the first states to mandate security treatment of LLC interests in certain circumstances. Other states should do the same. Although requiring LLCs to register their interests as securities will add filing and registration costs as well as hamper the ability of a newly formed LLC to attract additional investors, these disadvantages pale in comparison to the benefit of avoiding the loss of millions of passive-investor dollars. Furthermore, because the vast majority of businesses have less than thirty-five members, Wisconsin's statute will prevent abuse by fraudulent organizers while having no negative effects on the vast majority of LLCs.

V. Conclusion

Some will argue that only economic forces have driven the widespread enactment of LLC statutes, and that many state legislatures have been passing legislation simply to stay competitive with other states. Undoubtedly, prevention of lost revenue has been a major impetus in most, if not all, states enacting LLC legislation. Simple market forces drive potential investors to the entity that offers the most flexible, advantageous, and economical alternative. If a particular state does not have

\[\text{Wis. Stat. } \S\S\ 551.02(13)(b)-(c)(1993-94).\]

the entity that investors desire, they will simply look to another state that does. While economic analysis may not, in the eyes of some, justify the business-favoring characteristics of LLCs, it is nevertheless a reality in today's global business world.104

On a more entity-specific level, commentators have observed that the LLC alternative is simply a form of business association that has been more or less approximated by combining the traditional business entities:

Recognizing LLCs as partnerships grants no new tax bonanza, but rather makes available in a straightforward form that which has almost always been available with various degrees of complexity. For example, taxpayers have sought, with considerable success, to achieve partnership taxation without personal liability through the use of limited partnerships with corporate general partners, sometimes using S corporations for this purpose.105

When looking at the LLC from this perspective, it is difficult to dispute the fact that the LLC is filling a gap in the traditional menu of entity choices.

As with any new entity, there will be initial problems that can only be discovered through trial and error. These are not, however, reasons to disregard the entity as a whole. Given the advantages discussed above, the LLC will undoubtedly surpass the other pass-through entities as the predominant form of organizing a business. The table is being set as the final few states adopt LLC legislation. Soon everyone will be able to eat and enjoy their cake.

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