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Forward: Understanding the Place of Limited Liability Companies in the Spectrum of Business Forms

Charles R.T. O'Kelley
University of Georgia School of Law, okelley@uga.edu

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Symposium on Oregon's Limited Liability Company Act

CHARLES R. O'KELLEY*

Foreword—Understanding the Place of Limited Liability Companies in the Spectrum of Business Forms

FOR most of this century, state law has provided participants in jointly owed business ventures with three principal business forms—the corporation, the general partnership, and the limited partnership. In the past four years, over two-thirds of the states, including Oregon, have enacted legislation authorizing a new business form—the limited liability company (LLC). It appears likely that the LLC will soon supplant the two forms of

* Dean 1994-1996 and Loran L. Stewart Professor of Business Law, University of Oregon School of Law.

partnership as a principal business form, and that it will challenge the corporation as the form of choice for closely held firms.[1]

Corporate form separates ownership function into three realms: (1) the shareholder's residual claimant realm; (2) the directors' monitoring realm; and (3) the specialized managerial services realm of the officers. Additionally, corporate form insulates shareholders, directors, and managers from personal liability for corporate obligations. Finally, even major changes in corporate form or policies are decided by majority rule. These corporate attributes make corporate form ideal for firms that need to: (1) obtain substantial amounts of capital from public investors; (2) obtain specialized management and monitoring services from another set of individuals; and (3) quickly adapt to changed circumstances. Conversely, corporate form is not as ideal for firms that do not need to raise capital from passive, widely dispersed investors, and, therefore, do not need to employ directors to monitor the activities of managers to ensure that passive investors' interests are protected.[2]

Many commentators argue that general partnership form reflects and protects the expectations and needs of the archetypical closely held firm[3] better than does corporate form.[4] The standard form provisions of partnership law grant all ownership functions to the general partners. Moreover, changes to the partnership agreement or decisions, other than ordinary business matters, require the consent of all partners. Thus, partnership law's default rules guarantee that partners may serve the partnership as long as they choose and may not have their share of profits reduced without their consent. Moreover, unlike corporate form, which provides liquidity in form but not substance to investors in closely held firms, general partnership form ensures li-

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[1] *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U.L.Q. 417 (1992).

[2] For an economic analysis of the corporate form see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); FOUNDATIONS OF CORPORATE LAW (Roberta Romano ed. 1993); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (1985).

[3] The archetypical closely held firm is a jointly owned enterprise with modest capital needs whose owners are able to both manage the firm and effectively monitor each other to prevent misconduct or shirking.

[4] *See* John A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977).

quidity to investors. Any partner may dissolve the partnership at will, and then require that the partnership assets be sold and the proceeds be distributed to each partner according to her share.

For "in-between" closely held firms[5] neither partnership or corporate form is ideal. Both managers and investors in these firms may strongly prefer corporate law rules insulating them from personal liability for other than personal misconduct. Additionally, partnership dissolution-at-will rules may impose unacceptably high risk of minority opportunism. On the other hand, corporate law's majority rule, separation of function, and entity permanence may expose minority investors and managerial employees to significant risk of majority opportunism. Moreover, choice of corporate form exposes the incorporated enterprise to federal income tax treatment as a corporation rather than as a partnership.

LLCs may prove ideal for in-between closely held firms. Generally speaking, the LLC: (1) offers passive investors and active participants limited liability; (2) provides default rules that ensure taxation as a partnership; and (3) ensures liquidity to withdrawing members while providing a modicum of entity permanence and protection from minority opportunistic withdrawal.

The catch in this summation is the modifier "generally." The downside of the LLC phenomena is the lack of uniformity and certainty that will exist for some period of time. The acts adopted by the various states differ in subtle but important ways. Further, there is no case law to rely on in interpreting the statute of a particular state. Accordingly, practitioners can take no comfort in statements that purport to provide a general characterization of the LLC.

This Symposium presents an array of articles addressing the Oregon Limited Liability Company Act (the Act). The articles are designed to give both practitioners and policymakers insight into both Oregon's version of the LLC and its cousins in other jurisdictions.

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[5] By "in-between" closely held firms, I mean firms with a significantly greater need for adaptability and capital than the archetypical closely held firm, but which do not have sufficient need for capital or adaptability to justify becoming publicly traded firm. For comparative analysis of the organizational needs of firms depending on their relative need for capital and adaptability see Charles R. O'Kelley, *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 Nw. U. L. Rev. 216 (1992).

The first two articles provide a comprehensive overview of the tax ramifications of selecting an LLC. David Culpepper leads off with a complete analysis of the Internal Revenue Service Regulations and rulings determining whether an LLC will be classified as a partnership or a corporation for federal income tax purposes. Mark Golding then examines the tax consequences of converting an existing partnership or corporation into an LLC.

An issue of importance for at least the short term is what law will govern an Oregon LLC that conducts business in states that do not recognize LLCs. Erich Merrill explores the conflict of law rules and factors that will govern a forum state's resolution of this issue, and pinpoints the role of private ordering in maximizing an Oregon LLC's chances of receiving a favorable result.

The Symposium next moves to a consideration of the default rules of Oregon's Act as they relate to internal governance of an LLC. Mark Golding examines in detail the financial aspects of an Oregon LLC. Practitioners and students alike will find Golding's use of hypotheticals particularly helpful, as well as his integration of tax considerations into his analysis. Thomas Sayeg then focuses on the flexibility of the management provisions of Oregon's Act.

The Symposium concludes with four student pieces. John Martel and Tanya Hanson address the fiduciary duty aspects of LLCs, including comparisons with other business forms. Patrick Inouye provides an overview of the lack of uniformity in existing state LLCs acts and provides insight into how this new business form is likely to evolve. Finally, David Kopilak offers an articles of organization and operating agreement checklist for Oregon LLCs.