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West Virginia's Limited Liability Company Act: Problems with the Act

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# WEST VIRGINIA'S LIMITED LIABILITY COMPANY ACT: PROBLEMS WITH THE ACT

**ANN MAXEY***

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I. INTRODUCTION

West Virginia, in 1992, was the thirteenth state to enact a limited liability company act. The Act gave West Virginia business planners another option in choosing a form of entity that best meets the needs of owners forming a business. Before limited liability companies be-

came an alternative, participants who wanted to co-owned a business had four forms from which to choose—partnerships, limited partnerships, corporations taxed as C corporations, and corporations taxed as S corporations.

Partnerships offer the advantages of flexible flow-through taxation that allows the partners to decide how to allocate profits and losses and to share distributions among themselves. This flexibility produces the optimum method under the present federal income tax system to reduce the tax liability of the individual partners and to allocate profits according to each partner's economic contribution to the business. A significant drawback of the partnership form is that each partner has unlimited liability for business liabilities and for the other partners' actions on behalf of the partnership.

The limited partnership form maintains the favorable partnership taxation treatment, and the limited partners enjoy limited liability. Each limited partnership, however, must have at least one general partner who continues to have unlimited liability, and the limited partners will lose their limited liability protection if they actively participate in the business.

State corporation statutes limit the liability of shareholders to the amount the shareholders have invested in the business even though the shareholders actively participate in the business in capacities as directors, officers, and employees. Corporations taxed under the federal taxation scheme as C corporations are taxed, however, at the entity level, and when the profits are distributed to shareholders, the profits are taxed again at the shareholder level, resulting in double taxation. If shareholders meet certain qualifications, they can elect to have their corporation taxed as an S corporation, which permits the corporation's income to be taxed only at the shareholder level. However, the S corporation taxation scheme is inflexible, complex, and not as favorable as compared to the partnership taxation alternative.

2. The S corporation is limited to 35 shareholders, all of whom must be natural persons (with the exception of certain trusts). Nonresident aliens are not permitted shareholders. The federal income taxation treatment of S corporations is not flexible because an S corporation can have only one class of stock. This requirement precludes the differing distribution and voting provisions often found desirable in private businesses. The tax treatment accorded
The new business form enacted in West Virginia and in thirty-five other states as of March 1994, known as a limited liability company, confers state law limited liability on the co-owners, known as "members." The provisions of the limited liability company acts then weave their way through the intricate requirements of the federal tax code so companies formed under the acts are taxed as partnerships. The result is a business form in which the members enjoy both limited liability and the advantages of flexible flow-through taxation of a partnership.

Limited liability companies, or LLC's, do not offer the perfect organizational structure for the formation of a closely-held business. All LLCs, in order to qualify for partnership taxation treatment, must lack at least two of the following three corporate characteristics—continuity of life, free transferability of interests or centralized management. LLCs formed pursuant to the WVLLC Act will always

S corporations is more complicated and less favorable to the taxpayer than partnership taxation. See Robert R. Keatinge et al., The Limited Liability Company: A Study of the Emerging Entity, 47 BUS. LAW. 375, 386-403 (1992), for a comprehensive comparison of the five business entity forms—general partnerships, limited partnerships, C corporations, S corporations, and LLCs.

3. Wyoming adopted the first LLC act in the 1970s, but the form did not generate significant interest until 1988 when the Internal Revenue Service issued a public revenue ruling that Wyoming LLC's would be treated as partnerships for federal tax purposes. Rev. Rul. 88-76, 1988-2 C.B. 360. Since 1988, states, in rapid succession, have either copied Wyoming's act so they could rely on Wyoming's favorable revenue ruling, or have enacted variations of Wyoming's act and obtained revenue rulings to confirm partnership tax treatment. The National Conference of Commissioners on Uniform State Laws is in the process of drafting an act. Most states have not waited for the completion of a uniform act before adopting an LLC act.

In March 1992, West Virginia became the thirteenth state to enact a comprehensive limited liability company act. By March 1994, thirty-six states had adopted LLCs Acts and another five states had bills in their legislatures. Susan Pace Hamill et al., Tax Aspects of Limited Liability Companies, 836 P.L.L/CORP 357 (1994). As the number of states adopting LLCs approaches fifty, one of the stumbling blocks to the acceptance of the new business form—the uncertainty whether the limited liability of LLC members would be respected in all states where a company conducts business—will be eliminated. Whether the form will replace general partnerships, limited partnerships, and S corporations for most closely held enterprises remains to be seen. The West Virginia Secretary of State's office reported that since enactment, approximately 400 LLCs had been organized compared with approximately 3,000-4,000 incorporations during the same period, giving some idea of the acceptance of this form of business organization in West Virginia.
lack the two corporate characteristics of continuity of life and free transferability of interests.

Because a WVLLC lacks continuity of life, it can be dissolved and the business itself can be liquidated in the same way as a partnership can be dissolved, such as at the death of a partner. The business planner must trade off the LLC’s desirable features of limited liability and partnership taxation for the LLC’s potentially undesirable feature that the company will dissolve and its assets be liquidated at an unexpected time, such as a time when the members could lose their entire investment or before the business turns a profit. The lack of continuity of life is a feature that the WVLLC shares with other state LLC statutes and is likely to be a limiting factor in deciding which business form to use.

The WVLLC Act contains some unique provisions that result in members bearing additional risk of liability not shared by LLC members who organize in other states or by shareholders in West Virginia corporations. This is unfortunate for at least two reasons. First, there is no policy justification for imposing more risk of liability on members of an WVLLC than is imposed on shareholders of a closely-held West Virginia corporation. Second, West Virginians, without a close reading of the statute, could be misled into thinking that the LLC form provided the same limited liability as enjoyed by shareholders. Indeed, the statute itself purports to grant to members the same rights and liabilities as shareholders in West Virginia. Other provisions then contradict that purported grant.

This article undertakes the first comprehensive analysis of the WVLLC Act. The first part orient the reader by reviewing the LLC’s basic terminology, which is followed by a discussion of federal

partnership taxation so that the tax reasons for the drafting of many of the basic LLC provisions can be understood.

The next section analyzes the Act's provisions in forming, dissolving, and merging LLCs. Unresolved problems in dealing with dissolutions and mergers have been created by the Act's insertion of corporate concepts of dissenters' rights into the basic statutory partnership concepts of dissolution procedure. The two concepts contradict each other.

The deficiencies and lack of clarity with respect to the rights and liabilities of both members and managers are focused in the fifth section. Those deficiencies, together with the members' liability to return distributions as discussed in section six, form the most serious problems in this first generation LLC statute because the issues raise uncertainties as to the extent of members' potential liability. These uncertainties should give parties and their advisors pause in using this new business form as it has been enacted in West Virginia.

The theme running throughout the analysis of the Act's provisions is that the Act lacks clarity in the conceptual ideas that form the basis of the new entity. The LLC form is a hybrid of both partnership and corporation law. The Act fails to address clearly which choice is to be taken where the concepts of partnership and corporation law conflict. The result is flawed in several respects. The statute should be corrected to enhance the utility of this new form of business organization.

Following the analysis of the Act's provisions, part eight alerts the reader to the impact of some of the other statutory laws of which a business planner should be aware in forming an LLC. Part nine suggests a few ideas for what kind of businesses the LLC form may be useful and when it should be avoided. The article concludes with a suggested approach in drafting a second generation statute.
II. BASIC CHARACTERISTICS OF WEST VIRGINIA LLCs

A. Terminology

Corporation and partnership law provide the concepts and some of the terminology used in drafting all limited liability company statutes.\(^5\) West Virginia’s LLCs are separate entities owned by “members” who form an LLC by filing “articles of organization” with the secretary of state.\(^6\) The filing of articles is analogous to filing articles of incorporation to form a corporation. A member, who can be an individual or entity, owns a “membership interest,” analogous to the owning of a partnership interest. The membership interest defines the member’s share of capital, the member’s interest in the profits and losses, and the member’s voting rights.

The members can exercise great flexibility in organizing and operating the LLC. If the members have not made an agreement on these matters, the LLC provides a series of default rules that act as a standard form contract among the members. The members may vary these default rules by entering into an “operating agreement,” which is analogous to a partnership agreement.

The operating agreement may be oral or written,\(^7\) although some of the Act’s provisions require certain agreements to be in writing if the parties desire to change the default rules. The operating agreements required to be in writing are usually the financial provisions, such as the way distributions are shared, or profits and losses allocated.\(^8\)

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5. See Keatinge et al., supra note 2, at 396.
8. The agreements required to be in writing are scattered throughout the statute. They are W. VA. CODE §§ 31-1A-20 (delegation of management to managers); 31-1A-23 (unpaid contributions to capital if agreement is to be enforced against member); 31-1A-24 (sharing of profits and losses); 31-1A-25 (sharing of distributions); 31-1A-35 (continuation of business after event of dissolution); 31-1A-43 (articles of merger); 31-1A-66 (waiver of notice) (1993). For an example of a sophisticated operating agreement, see Randolph M. Karsh et al., A MODEL LIMITED LIABILITY COMPANY OPERATING AGREEMENT, 836 P.L.I./CORP 689 (1994).
The members may govern the LLC with shared management authority as they would a general partnership, or they may agree to govern with all the formality of a corporation by electing "managers" to run the company. Managers may be entities, unlike a corporation's directors who must be individuals.  

B. Non-Corporate Elements

One corporate attribute, that other business forms do not share, is continuity of life. This attribute lends certainty in business planning because an unexpected event, such as a shareholder’s death, will not cause the business to terminate. An LLC, like a partnership, has no continuity of life. Upon an event of dissolution, such as a member’s death or resignation, the members must dissolve the LLC, wind up its business affairs, and distribute the assets. The business itself may continue if all of the remaining members agree to form a new LLC (without the withdrawn member) and agree to continue the business. The remaining members’ right to continue the business must be specifically stated in the WVLLC’s articles of organization. Because the members must wait until the dissolution event to reach an agreement to continue the business, any one of the members has the right not to agree to the business’s continuation. This uncertainty is an additional risk in using the LLC business form, and in some instances, may be an unacceptable risk to persons forming a business.

The shareholder of a corporation under normative corporation rules can freely transfer her shares, which includes all of her interests in the corporation, rights to dividends, and voting rights. The corporation and other shareholders have no say in the matter. This corporate charac-

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9. W. VA. CODE §§ 31-1A-2(10) and (13) (1993). A “Manager” is defined as a “person” and the definition of “person” includes individuals, corporations, general partnerships, etc. and other associations. A manager could thus be an entity such as a corporation, possessing its own limited liability with respect to liability arising out of its duties as a manager. Because managers in a WVLLC have the same “rights and liabilities as directors” in West Virginia corporations, see infra text accompanying notes 139-142, one wonders if the legislature intended that managers could limit their liability by incorporating, an opportunity not available to directors of corporations. The concept of an entity acting as a manager of an LLC is analogous to a corporation acting as general partner of a limited partnership.
teristic is known as free transferability of interests. The LLC lacks the corporate characteristic of free transferability of interests. A member’s interest in an LLC is assignable in the same way a partnership interest is assignable—that is, the member may assign to another the member’s rights to receive distributions. The assignee herself cannot become a member and assume a member’s rights in the management of the LLC unless all the members consent to the assignee becoming a member.

These two non-corporate aspects of the LLC—lack of continuity of life and lack of free transferability of interests—can limit the usefulness of the LLC as a business form compared to a corporation. But as discussed in the “Federal Taxation of LLC’s” section, it is these two characteristics that permit West Virginia LLC’s to be taxed as partnerships and not as corporations.

III. FEDERAL TAXATION OF LLC’S

A. In General

A limited liability company is useful to its members only if the characteristics of the limited liability company allow the entity to be taxed as an unincorporated association (i.e., partnership) rather than as an incorporated association (i.e., corporation) pursuant to the federal income tax laws. Partnership taxation rules of unincorporated associations permit the profits and losses of the business entity to flow through to the partners’ individual tax returns. Although a partnership files an information return with the Internal Revenue Service, the partnership does not pay taxes at the entity level. Profits and losses are allocated among the partners and included in each partner’s return.

10. The tax provisions and relevant issues have been discussed extensively in several comprehensive articles. See, e.g., Warren Gorham Lamont, Limited Liability Companies Offer New Opportunities to Business Owners, 10 J. PARTNERSHIP TAX’N 301 (1994) (a basic overview of LLC tax issues and comparisons with other business forms); Barbara C. Spudis, Limited Liability Companies, 342 P.L.L/TAX 843 (1993) (discussing specific tax considerations and advantages of LLC formation); MARTIN M. WEINSTEIN & JAMES J. DOHENY, Limited Liability Companies-General, MERTENS LAW OF FED. INCOME TAX § 35.359.10 (July 1993); and Mary L. Harmon, Federal Income Tax Considerations for Limited Liability Companies, 342 P.L.L/TAX 897 (1993). This article focuses primarily on West Virginia LLC governance rules which, in general, have received slight attention in the literature.
If the Service characterizes an entity as an incorporated association, the entity itself must pay taxes on its income, and any distributions to its owners may be taxed again at their respective individual tax rates. The result is that the entity’s income is taxed twice. Double taxation is the usual rule for all associations known for tax purposes as C corporations.\(^{11}\) Unincorporated organizations, such as an LLC, will be taxed as a C corporation unless the organization has more "noncorporate characteristics than it has corporate characteristics."\(^{12}\) If the characteristics are split evenly between corporate and noncorporate, the entity will be taxed as a partnership.

The Treasury Regulations identify six characteristics indicative of corporate status: (1) associates; (2) an objective to carry on business and divide the gains; (3) continuity of life; (4) free transferability of interests; (5) centralization of management; and (6) limited liability.\(^{13}\) All associations (partnerships or corporations) have, by definition, the first two characteristics—associates (two or more members) and an objective to carry on business. Only the next four characteristics are therefore considered. An unincorporated association must lack at least two of these four characteristics. By definition, an LLC has limited liability. Therefore, in order to ensure partnership tax status the LLC must lack at least two of the remaining three corporate characteristics: continuity of life, free transferability of interests, or centralized management.\(^{14}\)

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11. All corporations are taxed pursuant to Subchapter C of the Code (hence, "C" corporations) I.R.C. §§ 11, 61(a)(7) (1988), unless the corporation meets certain eligibility criteria and makes an election (in advance) to be taxed pursuant to Subchapter S of the Code (hence, "S" corporations) I.R.C. § 1361(b)(1) (1988). For state corporate law purposes, there is no difference between a C corporation and an S corporation.


Because an LLC must lack any two of the remaining three characteristics, a state statute creating LLCs could be drafted to allow the members, in their operating agreements, to select which two of the three characteristics the LLC should lack. The statute's default rules would select two of the characteristics to be lacking so that persons forming LLCs who did not vary the default rules would receive partnership taxation treatment.

This approach, taken by Delaware and Illinois, offers the members this kind of flexibility. If the members choose to vary the default rules in an operating agreement, they assume the risk that their variation will not restrict corporate characteristics sufficiently to provide the desired partnership taxation treatment. The flexibility offered by the LLC acts in Delaware and Illinois has not prevented the Service from issuing public revenue rulings holding that LLCs formed pursuant to those acts will be accorded partnership taxation treatment.

B. West Virginia's "BulletProof" Statute

Other states have taken a different approach, enacting so called "bulletproof" statutes, which do not permit the members to choose which two of the three characteristics they would restrict in their operating agreement. Instead, those states' statutes always choose to restrict free transferability of interests and continuity of life. LLCs formed pursuant to those acts will always lack those two corporate characteristics. The WVLLC Act is bulletproof. It does not permit the

17. The terms "bulletproof" and "flexible," and subsequent variations are used to describe LLC statutes in terms of their ability to satisfy Service requirements for partnership classification. A "bulletproof" statute is one which strictly adheres to the conditions restricting free transfer of interests and continuity of life as set forth in the original Rev. Rul. 88-76, 1988-2 C.B. 360. The Service has expanded its rulings, so more recently enacted LLC statutes tend to be more "flexible" in permitting members to choose which one of three corporate characteristics they desire.
LLC to have continuity of life, and it restricts the free transferability of members’ interests. Members may elect managers, thus varying the default rule that the members themselves will manage the LLC. The Act thus permits the corporate characteristic of centralized management. The Service has issued a public revenue ruling confirming that a West Virginia LLC will be classified as a partnership. The West Virginia Act’s provisions dealing with the three corporate characteristics—continuity of life, free transferability of interests, and centralization of management—are discussed below.

1. Continuity of Life

The Treasury Regulations state that an organization will lack continuity of life if the organization terminates when one of the original owners dies, retires, resigns, suffers insanity, goes into bankruptcy, or is expelled. If, on the other hand, the organization continues to exist after one of the dissolution events, then the organization will be deemed to have the corporate characteristic of continuity of life.

23. Continuity of life is a characteristic used to describe the length of time in which an entity may exist. If the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, then continuity of life does not exist. See CLARK BOARDMAN CALLAGHAN, Continuity of Life, MERTENS LAW OF FED. INCOME Tax § 35.359.40 (1993) for a comprehensive treatment. Treas. Reg. § 301.7701-2(b)(2) provides that the partnership (or operating) agreement may provide that the business will be continued by remaining partners (or members) in the event of a death or withdrawal of any member; however, the agreement does not establish continuity of life if under local law dissolution of the organization is automatic. Conversely, a contracted term of years within the organization agreement may limit the term of the LLC, but if state law permits continuity of life, the Service will follow state law and find that continuity exists even if the life was limited by agreement. Thus, state law LLC characteristics, as well as those contained in the partnership or operating agreements, are relevant in the determination of continuity of life.
A West Virginia LLC dissolves when its term has expired, the members unanimously agree to dissolve, or when one of the members dies, retires, resigns, is expelled, goes into bankruptcy, or "upon the occurrence of any other event which terminates the continued membership."

2. Free Transferability of Interests

If the owners have the power to transfer their interests freely without obtaining the consent of the other owners, the entity possesses the corporate characteristic of "free transferability of interests." The WVLLC Act does not permit free transfer of interests. It provides that a member can assign, in whole or in part, the member's right to share in the LLC's profits, losses, and distributions, but the member cannot transfer the right to participate in and manage the LLC. The assignee may become a member of the LLC only upon the consent of all the members.

3. Centralized Management

The corporate characteristic of "centralized management" exists when the powers to make business decisions are not vested with all of

the organization's owners. A corporation typically empowers a board of directors to make business decisions. Conversely, most general partnerships will automatically lack centralized management because, by statute, all partners have equal management rights. The WVLLC is flexible, granting the members the power to decide whether to manage the LLC like a general partnership, to manage the LLC like a corporation by electing managers, or to delegate some management functions to the members and some to the managers.

4. Two or More Members

An organization must have at least two members to secure partnership status and to avoid terminating the partnership status for tax purposes. The Internal Revenue Code defines the term partnership to include "a syndicate, group, pool, joint venture, or other unincorporated organization" that carries on any business. The regulations state that if there is only one remaining partner to carry on the partnership business, the partnership business itself is no longer carried on by the partners.

The WVLLC Act requires two or more persons to form a limited liability company. However, those persons need not be members of the limited liability company after formation. If the persons who form the LLC are not members of the limited liability company after formation,
tion, the company's existence for tax purposes will not begin until two or more members have received a membership interest in the LLC.\(^3\)

As argued throughout this article, West Virginia's current first generation LLC statute needs to be amended to correct some flaws, as well as to enhance the Act's usefulness. To make the Act more useful, West Virginia's second generation statute should include the flexibility of allowing members to vary the default rules to choose which two of the three corporate characteristics should be lacking. Those who wish to form uncomplicated LLCs can rely on the default rules to ensure partnership taxation treatment, and those who wish to vary the default rules can incur the cost of having sophisticated partnership tax planning included in their operating agreements.

IV. FORMING, DISSOLVING AND MERGING THE LLC

A. Formation

1. Articles of Organization

A WVLLC is formed in much the same way as a West Virginia corporation. Two or more persons form a limited liability company by signing articles of organization and delivering them to the West Virginia Secretary of State together with the filing fee.\(^3\)\(^4\) The existence of the LLC begins when the secretary of state issues a certificate of organization. Thereafter, the certificate of organization must be recorded in the county clerk's office of the county where the LLC has its principal office.\(^3\)\(^5\) This procedure, familiar to all who form corporations, is straight forward.

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35. W. VA. CODE § 31-1A-9(c), 31-1A-53 (1993) (foreign LLCs). If the LLC's principal office is not in West Virginia, then the certificate of organization must be filed in the county where the LLC conducts its affairs or transacts its principal business. If the LLC does not have a principal office and does not transact business within the state, the certificate need not be recorded in a county clerk's office.
2. Required Contents of Articles of Organization

The content requirements of articles of organization are similar to those prescribed for articles of incorporation. Articles of organization must state the name of the LLC, its period of duration (which cannot be perpetual), its purpose, the address of its principal place of business in the state, and the name and address of its initial registered agent.\textsuperscript{36} The articles must also contain a statement of the name and address of the persons or the firm preparing the articles of organization.\textsuperscript{37} The two or more persons who cause the limited liability company to be organized must execute the articles and have their signatures acknowledged.\textsuperscript{38} Unlike articles of incorporation, which require the names and addresses of the initial board of directors, articles of organization of an LLC do not require disclosure of the names of the members or the managers.

3. Recommendations For Including Other Provisions in Articles

The Articles may set forth any other matter permitted under the Act to be set forth in the operating agreement. At least two additional provisions should probably always be included in the Articles—the right of the remaining members to continue the business upon dissolution and the requirement that any operating agreement must be in writing.

If the LLC is dissolved prematurely, by a member’s death, for instance, the remaining members can continue the business only by the consent of all of the remaining members under a right to do so stated in the articles of organization. The parties therefore need to consider at the outset the issues arising in the event of a premature dissolution. For instance, consideration should be given to how a withdrawing member’s interest is to be paid, and whether such payment will cut off

\textsuperscript{36} W. VA. CODE § 31-1A-8 (1993).
\textsuperscript{37} W. VA. CODE § 31-1A-8(e) (1993).
\textsuperscript{38} W. VA. CODE § 31-1A-8(f) (1993).
the withdrawing member's right to force liquidation. Unfortunately, the Act’s provision requiring the right to continue to be stated in the articles is buried in another section of the Act.\textsuperscript{39} The Act should at least be cross-indexed so that these provisions are not overlooked.

The WVLLC Act, because of inconsistencies and deficiencies in the default rules,\textsuperscript{40} demands the members to enter into a well drafted operating agreement. An operating agreement can be oral or written.\textsuperscript{41} A written agreement should clarify the member's agreements and help avoid future misunderstandings. The written operating agreement, however, can be modified by subsequent oral amendments unless the articles require that amendments to the operating agreement be in writing. This procedure should always be followed so the members are specifically aware of when and how they may modify their operating agreement.

4. Name

The name of a limited liability company must not be deceptively similar to any domestic or foreign corporation, limited partnership, or limited liability company organized in or authorized to transact business in the state or any name registered in the state. The name cannot contain any words used to signify a corporation (e.g., Inc. or Corp.) or a limited partnership or words to imply that it is organized for an impermissible purpose.\textsuperscript{42} The name must contain the words "limited liability company."\textsuperscript{43} However, the Act fails to provide for the name to substitute abbreviations, such as LLC, for the words "limited liability company." Like domestic corporations, names can be reserved for a period of 120 days, and the reservation may be renewed for an additional 120 days.\textsuperscript{44} There is no provision that permits names to be reg-

\begin{itemize}
  \item \textsuperscript{39} W. VA. CODE § 31-1A-35(a)(3) (1993) allows members to consent to continuation as long as that right is stated in the articles of organization.
  \item \textsuperscript{40} See supra text accompanying notes 31-33 and \textit{infra} text accompanying notes 70-71.
  \item \textsuperscript{41} W. VA. CODE § 31-1A-19 (1993).
  \item \textsuperscript{42} W. VA. CODE § 31-1A-5(d) (1993).
  \item \textsuperscript{43} W. VA. CODE § 31-1A-5(a) (1993).
  \item \textsuperscript{44} W. VA. CODE § 31-1A-6 (1993).
\end{itemize}
istered as provided in the West Virginia Corporation Code, so foreign LLCs cannot preserve a right to a specific name in West Virginia for later use.

5. Amendments to the Articles

The LLC’s articles of organization are required to be amended within 30 days when the LLC changes its name, a false or erroneous statement exists in the articles of organization, the duration of the company changes, or the members desire to amend any agreement set forth in the articles of organization. If, however, the members’ agreements are contained only in an operating agreement, the articles will not need to be amended each time the operating agreement is amended. Articles of amendment are adopted by the majority vote in interest of the members, unless the articles of organization or the operating agreement provide a greater or lesser vote.

6. Registered Agents

West Virginia’s LLC Act requires that each domestic or foreign limited liability company continuously maintain a registered office and a registered agent. A limited liability company is required to file with the secretary of state a statement, within thirty days, of any change of its registered office or the registered agent. The registered agent of an LLC may resign as an agent by filing written notice of resignation with the LLC and the secretary of state.

The Acts’ provision providing a procedure for changing registered agents and offices offers an improvement over West Virginia’s Corporation Act. West Virginia’s Corporation Act does not address the issue of how an agent is to be changed or the agency terminated.

47. W. VA. CODE § 31-1A-11(c) (1993).
50. The failure of the West Virginia Corporation Act to deal with the change or resignation of a registered agent is attributable to the fact that the Corporation Act was passed in
In addition to the requirement that a registered office and a registered agent be maintained for each domestic and foreign LLC, the secretary of state acts as the attorney-in-fact for acceptance of service of process on behalf of both foreign and domestic limited liability companies.\(^{51}\) The Act's language appointing the secretary of state to act as the attorney-in-fact for service of notice and process is taken directly from the West Virginia Corporation Act. The provision permits anyone suing a limited liability company to effect good service on the limited liability company by serving the secretary of state.

**B. Dissolution**

1. **Voluntary Dissolution**

   Upon an event of dissolution,\(^{52}\) the members may wind up the LLC's affairs.\(^{53}\) The assets are marshalled and distributed in the fol-

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1974 when those provisions were not part of the *Model Business Corporation Act*. The certainty provided by the registered agent rules in the LLC is a welcome innovation. When an entity has gone into bankruptcy or is dormant, agents for service of process have frequently been required to accept service of process, are unable to find persons associated with the entity, and have no statutory procedure to resign their agency.

52. *W. Va. Code* § 31-1A-35 (1993). Dissolution under the Act occurs upon the occurrence of the following: (1) the period fixed for the LLC's duration expires; (2) unanimous written consent of all members; (3) the death, resignation, bankruptcy or dissolution of a member or any other event which terminates the continued membership of a member in the LLC; or (4) decree of judicial dissolution pursuant to *W. Va. Code* § 31-1A-36 (1993). Members may consent to continuation of the business if written in the articles of organization in the case of a member's termination under (3) which triggers dissolution.
53. *W. Va. Code* § 31-1A-37 (1993). In the absence of an agreement designating who can wind up the LLC's affairs, the statute leaves the procedure to "the members who have not wrongfully dissolved a limited liability company." A dissolution will occur even when a member in breach of an operating agreement resigns. Presumably the resigning member would have wrongfully dissolved the LLC in breaching the operating agreement and would therefore not be entitled to wind up the LLC's affairs. Although a court may specifically enforce an operating agreement by injunction, *see* *W. Va. Code* § 31-1A-19(e)(1) (1993), it is doubtful that a court would prevent a member from resigning. Presumably, the member would have to respond in damages for breach of the operating agreement.

The members presumably could either designate someone, including a manager, to wind up the LLC's affairs or could act jointly by vote of the majority in interest.
lowing order: (1) to secured creditors to the extent of their security; (2) to unsecured creditors; (3) to members who are creditors as a result of unpaid distributions; and (4) unless otherwise agreed, to members first for the return of their contributions, and second, in the proportions members share in distributions.54

Upon the completion of the winding up, the LLC files a certificate of cancellation with the secretary of state, who in turn issues a certificate of dissolution.55 If the certificate of organization had been filed in a county, the company ceases to exist when the certificate of dissolution is filed in the same county.56

The procedure for a voluntary dissolution appears straightforward when viewed in the context of winding up and liquidating a partnership. Unfortunately, one obscure provision raises vexatious issues. Each member has a right to dissent to any sale or exchange of all or substantially all of the property and assets of the LLC not made in the usual course of its business, including "a sale in dissolution."57 The dissenters’ rights trigger a procedure in which the LLC must pay the dissenter the fair value of his interest, and if the parties cannot agree as to the amount, each may apply to the court to obtain a determination of fair value.

This provision is taken from the West Virginia Corporations Act and is placed in the WVLLC Act within the several provisions dealing with LLC mergers.58 A member’s right to dissent in a dissolution and to be paid the fair value of his interest is inconsistent with a dissolu-

56. W. VA. CODE § 31-1A-40 (1993). Section 31-1A-40(c) refers to the limited liability company as the "corporation." W. VA. CODE § 31-1A-40(c) (1993). The reference needs to be corrected—corporation status is not desired.
58. See infra text accompanying notes 91-95 for a discussion of dissenters’ rights upon mergers.
tion procedure in which the assets are liquidated and the priority of the payment of the proceeds is fixed by statute. It is doubtful that a dissenting member would be allowed to improve his priority order or increase the amount he would receive upon liquidation. In most situations, all the members would have the same incentive to receive the highest possible price for the assets so they could divide the residue in accordance with their distribution agreement. Dissenters' rights in dissolutions are not needed and only add confusion to the fixed statutory dissolution procedure.

The dissenter provision could be useful theoretically, however, in the following situations. First, if the LLC sold substantially all of its assets, under the terms of the operating agreement, it is not required to dissolve, and if those who manage the LLC decided not to distribute the proceeds, the dissenter could force the managers to pay the dissenter's interest. In that situation, however, the member should also have the remedy to seek a judicial dissolution even if he did not have dissenter rights. Second, if, in liquidating the company, the majority in interest want to purchase the LLC's assets at a bargain price so that the minority will not receive fair value for their interests, the minority could dissent. Presumably the minority could in that situation seek a court supervised liquidation, but the dissenter's right to fair share is stated concretely in the statute. The minority therefore would not have to rely on the uncertainty of a court's discretion in the matter.

Even if neither of those situations occur, thorny business issues often crop up in liquidating the assets, identifying and paying the creditors, and distributing the remaining assets to the members. Unless the minority could show some unfairness, presumably they would have to wait at the end of the line with the rest of the members. Unless otherwise agreed, the members have no right to receive distributions other than in cash, and the members cannot be compelled to receive a distribution in kind greater than their proportionate share of the asset.

The statutory dissolution procedure has been established in partnership law and is appropriate in the dissolving and winding up of a

business entity that lacks continuity of life. The novel idea of incorporating dissenters’ rights of corporate law into that established procedure is both unnecessary and confusing. The drafters of the second generation WVLLC should reconsider the provision.

In the LLC dissolution process, the relative rights and duties between members and creditors are unclear. The members are faced with vague, contradictory, and uncertain liabilities in dealing with creditors which are discussed in section VII of this article.

2. Judicial Dissolution

A member can apply to a circuit court of a county in which the registered office of the limited liability company is located (which need not be the LLC’s principal office) for a decree of dissolution. The circuit court’s discretion to enter a decree of dissolution is not circumscribed by specific standards as stated in the statutes regulating involuntary dissolution of a general partnership and involuntary dissolution of a corporation. The circuit court need only find that “it is not reasonably practical to carry on the business in conformity with the articles of organization or any operating agreement.”

Courts need not usually resort to this drastic remedy because they are specifically empowered to enforce operating agreements by injunction or other relief that the courts deem to be fair or appropriate in the circumstances. The courts, in exercising their discretion, most likely would rely on the kind of circumstances in which partnerships or corporations have been dissolved. The absence of stated standards, how-

62. W. VA. CODE § 47-8A-32 (1993) (stating that upon application by or for a partner, the court shall order dissolution when a partner has been declared a lunatic, is incapable of performing his part of the agreement, acts illegally to the detriment of the partnership, breaches the agreement wilfully, or when the partnership is insolvent). W. VA. CODE § 31-1-41 (1993) (stating that the court may order liquidation upon showing of director deadlock and irreparable injury, illegality, oppressive or fraudulent conduct, corporate assets misapplied or wasted).
65. See, e.g., Masinter v. WEBCO Co., 262 S.E.2d 433 (W. Va. 1980) (oppressive
ever, could signal to courts that they had more discretion in liquidating LLCs, and therefore they may err in using their discretion too freely.

In a judicial dissolution, the assets are marshalled and distributed in the same order of priority as in a voluntary dissolution. If a court decides a dissolution is the appropriate remedy, the court supervises the winding up of the LLC. A certificate of cancellation is then filed. A judicial dissolution does not limit a creditor’s rights to sue the dissolved LLC.

3. Members’ Rights to Continue Business on Dissolution

The Act’s rules governing the members’ rights with respect to each other upon an event of dissolution appear, at first, to look similar to the rules governing partnership dissolution. The Act’s variations from partnership law, however, have produced a set of incomprehensible dissolution default rules concerning members’ rights upon an event of dissolution. The good news is that these default rules can be changed by an operating agreement. If the parties rely on the default rules, the bad news is that a lot of expensive mischief could result.

Most partnership rules dealing with dissolution can be changed by agreement so that an event of dissolution does not trigger the premature liquidation of the business. From an economic perspective, the owners of a business do not want to risk that an unexpected event, such as a partner’s death, would occasion an untimely liquidation of the business causing the partners to lose their investment or fail to realize the profits they had anticipated.

Partnership agreements are drafted to prevent this result, and in LLCs, the members can draft operating agreements to prevent this result. But what are the results when three members form a hand-shake LLC in West Virginia and expect to rely on the default rules to meet their expectations in dealing with each other in the event of a dissolution? First the partnership dissolution default rules will be described, and then those rules will be contrasted with the Act’s dissolution rules.

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If a partnership is not formed for a particular term or a specific undertaking, the partnership is at-will, which permits any partner at any time to dissolve the partnership without violating an agreement between the partners. Most partnerships are partnerships at will. For example, when persons decide to practice medicine, accounting, or law together, they usually form a partnership with the expectation that any of them can leave at any time. If a partner decides to leave, each of the partners, including the one who wishes to leave, has the right to liquidate the business of the partnership, to apply the partnership property to discharge its liabilities, and to pay in cash all remaining amounts to the partners in proportion to their respective interests.

Because the withdrawing partner will continue to have unlimited liability to the partnership’s creditors whose claims arose before the dissolution, the withdrawing partner’s right to liquidate the business and to pay the creditors makes sense. If the other partners want to continue the business, they must negotiate with the withdrawing partner to buy his partnership interest in the shadow of the withdrawing partner’s right to liquidate the business. The withdrawing partner will want to be paid the fair value of his interest and will want to protect himself from the liabilities owed to the partnership’s creditors. The withdrawing partner will have an incentive to make an economic decision not to liquidate the business prematurely because all of the creditors might not be paid. He may also have an incentive to act opportunistically to demand an unfairly high price for his interest which the remaining partners will have to meet if they want to continue the business. His price negotiations will be limited by (1) his share of partnership liabilities if the business is liquidated, and (2) an amount

67. If the partners have agreed to form a partnership for a definite term or undertaking, a dissolution at the will of less than all of the partners will be in contravention of the partnership agreement, and the partner who wrongfully caused the dissolution will not have a right to liquidate the business. W. VA. CODE §§ 47-8A-31(1)(b), -38(0)(l), -38(b)(t)(l)(I) (1993). UNIF. PARTNERSHIP ACT §§ 31(1)(b), 38(e)(l), 38(e)(II).

68. The death or the bankruptcy of a partner also causes a dissolution, but the Uniform Partnership Act is not clear whether the partner’s representative has the right to force liquidation. In these circumstances, each of the other partners has a unilateral right to force the liquidation. UNIF. PARTNERSHIP ACT § 38; W. VA. CODE § 47-8A-38 (1993).
at which it is less expensive for the other partners to liquidate the business than to pay him the value of his interest.

The WVLLC Act also provides a default rule for an LLC-at-will. The Act provides that unless otherwise agreed, a member may resign\(^69\) upon giving six months written notice to the other members. The member’s resignation causes a dissolution “unless the business of the limited liability company is continued by the consent of the remaining members under a right to do so stated in the articles of organization.”\(^70\)

The Act does not state what the resigning member’s rights are with respect to forcing liquidation of the business or being paid for his membership interest. If the LLC articles permit the right to continue upon unanimous consent of the remaining members, but do not provide for payment of the resigning member’s interest, what remedies does that member have? Does he have a right to be paid a fair value for his interest? Can the remaining members continue to use the capital without compensating the resigning member? Has the member impliedly agreed that his money will stay in the LLC by his act of contributing money to an LLC with the continuance provision in its articles? Has the LLC impliedly agreed to pay the member the fair value of his interest by containing in its articles a right to continue the business?

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\(^69\) The section states a member may “withdraw or resign”, but fails to make a distinction between a withdrawal or a resignation. W. VA. CODE § 31-1A-27 (1993). The member’s right to resign at will is not circumscribed by the partnership exception that a partnership at will does not exist if the parties have agreed on a definite term or a particular undertaking. Under partnership law, a partner who withdraws prior to the end of the term or undertaking has withdrawn in contravention of the partnership agreement and has relinquished his unilateral right to cause the business to be liquidated. UNIF. PARTNERSHIP ACT § 38; W. VA. CODE § 47-8A-38 (1993).

Arguably, the duration of the LLC as stated in the articles of organization could be construed as an agreement among the members not to withdraw before that term has expired. However, that position should be rejected for at least two reasons. First, a statutory provision allowing a member to resign would make no sense because all LLCs formed in West Virginia will have a duration time stated in their articles. A member’s resignation before that time would always be wrongful. Second, the statute specifically permits a member to withdraw with notice (unless otherwise provided in the articles or an operating agreement). If the member acts pursuant to a right granted by statute, his actions should not be wrongful.

\(^70\) W. VA. CODE § 31-1A-35(3) (1993).
Can the resigning member apply for a judicial dissolution upon the ground that he has not been paid fair value? If the articles do not contain a continuance provision, can the majority vote to amend the articles during the six month notice period to provide for the right of continuance?

These issues will not just arise when a member resigns, but will have to be addressed if a member dies, retires, is expelled, declares bankruptcy, or is dissolved. All of those events trigger dissolution unless the remaining members agree to continue the business under a right to continue stated in the articles.

A default rule that allows the remaining members to continue the business of the LLC, but does not address how the withdrawing member’s interest is to be paid, is fertile litigation ground. The statutes should provide more effective default rules that will lend the certainty needed in these business transactions.

Partnership law permits any partner to liquidate if the parties cannot agree on how the withdrawing partner is to be paid. This approach is not appropriate for an LLC because a member does not have unlimited liability and therefore does not need this protection. A disgruntled member could use the power to liquidate to extract an unfairly high price for his interest without the need to take into consideration the business’s continued success in order to pay the creditors.71

Corporations have continuity of life, so this issue does not arise when a shareholder dies. A shareholder also does not have a statutory right to withdraw her capital from the corporation. Corporation default rules permit a shareholder to transfer her shares freely if she no longer wishes to participate.

LLC default rules could permit a member to resign with notice and provide that the LLC will pay the member the fair value for her interest if the payment would not cause the LLC to be insolvent. Virginia and Delaware LLC Acts, for example, provide for this pay-

71. The member would still be liable for an amount not exceeding the amount of his returned contribution, if any, to those creditors who claims arose before the return of his contribution. W. Va. Code § 31-1A-32(d) (1993). But assuming all returned contributions have been exhausted in paying creditors, some claims may still be left unpaid.
ment. However, their rules only partly address the problem. They do not limit the resigning member to only this remedy; they give no guidance as to how the fair market value is to be determined; they do not state what happens in the event an LLC is unable to make the payment without violating the insolvency tests; and they make no provision for paying the fair value of the interest of a member who dies or retires, when the remaining members want to continue the business.

In short, the statutory right of the remaining members to continue the business in the event of a dissolution and the right of a member to withdraw remains uncertain unless the LLC has a well drawn operating agreement. Members who form an LLC in West Virginia and risk their contributions in a business that may dissolve prematurely may be unpleasantly surprised that the LLC business form does not provide a framework in which to solve these serious business issues.

C. Registration of Foreign LLCs

Foreign LLCs may transact business in West Virginia after obtaining a certificate of authority. The Act’s provisions dealing with the registration of foreign LLCs were taken almost verbatim from West Virginia’s Corporation Act. These foreign LLC registration provisions become important if, because of the uncertainties as to the WVLLC Act, parties choose to form a foreign LLC and register the foreign LLC to transact business within West Virginia.

The Act states that the foreign LLC’s jurisdiction will govern the entity’s internal affairs and the liabilities of its members. To the extent that foreign LLC acts offer rules that parties, or their advisors, find more attractive than the WVLLC Act in governing an LLC, so-

phisticated business persons may choose to organize their LLC in the foreign jurisdiction and then register the LLC to transact business in West Virginia.\textsuperscript{75}

A foreign LLC must only register if it is "conducting affairs or doing or transacting business" in the state. A statutory provision contains a laundry list of twenty-two different activities in which an LLC may engage without being considered to be conducting affairs or doing or transacting business in the state. The list is not exhaustive.\textsuperscript{76}

If registration is required, the procedure for obtaining a certificate of authority for a foreign LLC is as follows. The foreign LLC files an application with the secretary of state for a certificate of authority. The application sets forth almost identical information required by the domestic LLC's certificate of organization.\textsuperscript{77} The secretary of state issues a certificate of authority which is then filed in the county of the LLC's principal office or in any county in which the foreign LLC is transacting business. The LLC is required to appoint and continuously maintain a registered agent in the state and file the same reports as required of domestic LLCs.\textsuperscript{78}

The foreign LLC is required to file statements or documents with the secretary of state when certain events occur, including amendments to its articles of organization, articles of merger, a change of name, or a change of business purpose.\textsuperscript{79} A foreign LLC can withdraw its au-

\textsuperscript{75} See infra part X.

\textsuperscript{76} W. VA. CODE \$ 31-1A-49(b)(1) to -49(b)(22) (1993). The list of these activities rewritten in slightly different form was taken from the West Virginia Corporation Act, W. VA. CODE \$ 31-1-49 (1993).

\textsuperscript{77} Compare W. VA. CODE \$ 31-1A-82 (1993) and W. VA. CODE \$ 31-1A-52 (1993).

\textsuperscript{78} W. VA. CODE \$ 31-1A-63 (1993). The Act's provisions are sometimes duplicated, inconsistent and confusing. For example, W. VA. CODE \$ 31-1A-55 (1993) (taken from W. VA. CODE \$ 31-1-56) states that a foreign LLC may appoint or change a person to whom notice or process may be served by filing a statement containing certain information with the secretary of state. W. VA. CODE \$ 31-1A-63 (1993) deals with the same subject, but requires a foreign LLC to maintain continuously a registered agent as required of domestic LLCs. The specific requirements of W. VA. CODE \$ 31-1A-63 are presumed to control over the permissive provisions of W. VA. CODE \$ 31-1A-55.

\textsuperscript{79} A foreign LLC is not permitted to transact any business in the state other than for the purpose stated in its application for a certificate of authority. However, the application should be able to state that the foreign LLC is being registered to transact any lawful busi-
The foreign LLC’s failure to obtain a certificate of authority will result in the foreign LLC not being permitted to maintain an action or proceeding in the state’s courts. If the LLC should have, but failed to, obtain a certificate of authority, the foreign LLC will have to pay all fees, taxes, and penalties due as a prerequisite for obtaining a certificate of authority. If the LLC is sued, it will have to register before it can bring a counterclaim in the suit. The LLC’s failure to obtain a certificate of authority, however, does not impair the validity of any contract nor does it prevent the LLC from defending any action or proceeding in the state’s courts.

Virginia adapted the more recently drafted and more streamlined provisions of its Uniform Limited Partnership Act as the registration provisions for foreign LLCs. West Virginia could have used the Virginia LLC model as West Virginia did with respect to many other provisions. West Virginia could have also adapted its own Uniform Limited Partnership Act registration provisions and reached the same result as Virginia. Instead, West Virginia chose to adapt for use in the Act’s foreign registration provisions, the dated, more verbose, provisions of the West Virginia Corporations Act. The choice of adapting several provisions from the West Virginia Corporations Act may have been in keeping with the WVLLC Act’s stated provision that members have the same rights and liabilities as West Virginia shareholders. The result of choosing the corporation language is unfortunate because no reason exists for some of the corporation provisions except the historical state of the law at the time the original corporations statute was enacted in 1974. The result is that some provisions contradict other provisions.

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82. See infra text accompanying notes 139-154.
83. For instance, the drafters included in W. VA. CODE § 31-1A-55 (1993), a provi-
D. Conversions and Mergers

The WVLLC Act permits domestic and foreign partnerships (general and limited) to convert into domestic LLCs. Apparently only Virginia and West Virginia have a conversion of partnership privilege, which provides certainty to the partners and third parties in choosing the business entity most suitable for the parties’ needs. The Act also permits domestic and foreign LLCs to merge with each other. The Act’s conversion provision is similar to Virginia’s. However, Virginia’s merger provision is more flexible because a domestic LLC may merge with one or more domestic or foreign LLCs, limited partnerships, or corporations. The reasons are not apparent why West Virginia has limited its merger privilege simply to other LLCs rather than adopt a more flexible approach. There are a number of tax planning and other legitimate business reasons for LLCs to merge with other entities. For instance, an S Corporation may want to add an investor that is not eligible to be an S Corporation shareholder. The S Corporation should be able to convert or merge into an LLC.

When a domestic or foreign general or limited partnership is converted into a domestic LLC, the LLC is formed by filing articles of organization, which in addition to the other information required, will include the name of the former general partnership or limited partnership. The conversion itself causes the partnership’s assets to be transferred to the LLC by operation of law without further act and without any reversion or impairment. If the partnership held title to real estate

87. Va. Code Ann. § 13.1-1010.2 (Michie 1993) (conversion, Virginia); Va. Code Ann. §§ 13.1-1070 to -1073 (Michie 1993) (merger). Other states approach the issue of conversion and mergers differently. For instance, Delaware does not have a conversion provision; however, Delaware provides that a domestic limited liability company may merge or consolidate with or into any other business entity (LLC, corporations, business trusts or associations, real estate investment trusts, common law trust, or any other unincorporated business including a general or limited partnership). Del. Code Ann. tit. 18, §§ 209(a), (b) (1993).
in West Virginia, the LLC will need to file a confirmatory deed. The conversion does not cause a dissolution of the general partnership or limited partnership.\textsuperscript{88}

The Act's procedure for merger follows closely the language contained in the West Virginia Corporation Act. To merge, two or more LLCs enter into a plan of merger stating the names of the companies, the terms and conditions of the merger, the manner and basis of converting the membership interests of each company into the surviving company, and a statement of any changes in the articles of organization of the surviving company.\textsuperscript{89} The plan of merger must be approved by vote of the majority in interest of each company unless otherwise provided in each LLC's articles of organization or operating agreement.\textsuperscript{90} When the members approve, the LLCs then file articles of merger with the secretary of state. The articles of merger state the plan of merger, the number of membership interests outstanding as to each LLC, and the number of membership interests voting for and against the plan respectively. After filing, the secretary of state will issue a certificate of merger which must be filed in the county where each of the original certificates of organization was filed.\textsuperscript{91}

The Act's provision regarding the effect of the merger is again taken from the West Virginia Corporation Act.\textsuperscript{92} Upon the merger, the separate existence of each LLC ceases, and the surviving company has all the rights, privileges, immunities, and powers, and is subject to all the duties and liabilities of an LLC under the Act. The surviving LLC continues to be responsible for all liabilities and obligations of each LLC merged; any claim existing or action proceeding against the LLCs can be continued to be prosecuted as if the merger had not taken place; and the rights of creditors and lien holders are not impaired by the merger.

West Virginia's default rule requires a vote of the owners of a majority of the members' interests to approve the merger. Under the

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\textsuperscript{88} W. VA. CODE § 31-1A-47 (1993).
\textsuperscript{89} W. VA. CODE § 31-1A-41 (1993).
\textsuperscript{90} W. VA. CODE § 31-1A-42 (1993).
\textsuperscript{91} W. VA. CODE § 31-1A-43 (1993).
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Act, any of the members of the LLCs has a right to dissent to the plan of merger.93

If a member dissents, the member has to follow the rigid procedure set forth in the West Virginia Corporation Act.94 The procedure requires the dissenter to make a demand on the entity, and the entity must respond with a written offer to purchase the member’s interest for “fair value.” If the entity and the member cannot agree on the fair value of the member’s interest, the member or the entity can ask a court to determine the fair value of the member’s interest, and the LLC must then cash out the member.

If the majority in interest decides to merge, minority members will be able to exercise their dissenters rights to protect the value of their interests from an unfair valuation under the merger terms. Some interesting questions arise with respect to a member’s ability to dissent that are not present in a corporation setting. For instance, if a member dissents, does her dissent act as “any other event which terminates the continued membership of a member in the limited liability company” for purposes of dissolution? In other words, is the LLC dissolved by the member’s dissenting? If so, can the dissenter force the winding up and liquidation of the business? Are dissenters’ rights her only remedy?

Could a merger be used to circumvent the requirement of member unanimity for the admission of a new member? Suppose there are two members whom the majority want to join the LLC but who are opposed by other members. Could the two form an LLC and then merge the entities pursuant to majority vote? Would this action be deemed as not providing sufficient restrictions on free transferability so the LLC would be deemed to have too many corporate characteristics to be taxed as a partnership?95

93. W. VA. CODE § 31-1A-46 (1993). Section 46 states that the West Virginia Corporation Code procedures shall govern the dissenters’ procedures.
95. These issues don’t arise with respect to Virginia LLCs. Virginia provides that all the members must consent to the merger unless the LLC articles or operating agreement provide for a different method. VA. CODE ANN. § 13.1-1071 (Michie 1993). The members do not have dissenters rights, because they either can withhold consent or they have contracted away their ability to withhold consent to the merger by agreeing to a method of merger that requires less than unanimous consent.
The danger of importing whole concepts from corporation law and depositing them into a new structure like an LLC is that a whole range of issues arise that have not been considered. Dissenter rights would have better been omitted from the statute until the full import of those rights could have been more carefully considered.

A member also has dissenter’s rights with respect to the sale or exchange of substantially all of the property or assets of the LLC, including a sale in dissolution. The right to dissent in this context is discussed above with respect to the dissolution provisions.

V. MANAGEMENT

The WVLLC Act provides more flexibility than any other business form in deciding how and by whom the entity is to be managed. The members need only agree to the management structure in an operating agreement. The operating agreement does not have to be in writing. Members may retain, or delegate to managers, some or all of the power to manage the company.

Partnership default rules, on the other hand, give each partner equal rights to manage the affairs of the partnership. Partnership agreements can provide flexibility in achieving a different management agreement as between the partners. However, even if the right to manage has been withdrawn by the partnership agreement, each partner will continue to retain the power to bind the partnership. On the other hand, if managers are designated to manage the LLC, under the LLC statutes, only the managers (not the members) may contract on behalf of the LLC. Thus, the LLC Act provides a superior method to partnership law in implementing the members’ agreement to vest power to manage in only certain persons. The managers need not be members themselves. The LLC Act thus permits the members to achieve more certainty in choosing which persons can bind the business.

100. The LLC appears to be superior to the general partnership form because any part-
The LLC form is superior to a corporate management structure because even though in West Virginia shareholders can provide in the articles that the shareholders will manage the corporation, the shareholders are still restricted by the formalities of the corporate form.101 The troublesome aspect of the West Virginia LLC management structure is the uncertainty as to managers’ potential liability to the LLC and its members for making business decisions which later prove to be erroneous. To what extent can these risks be limited by agreement or indemnification?

A. Members

In the absence of agreement, the default rules provide that the members will manage the company by majority vote.102 Unlike the general partnership default rule that gives each member an equal vote, the Act’s default rule requires voting in proportion to each member’s capital contributions, as adjusted by additions and withdrawals.103 The member owning the majority of the capital interests (not necessarily the proportion in which members share profits) will determine all decisions. If the members retain the right to manage the company, each of the members can contract debts or incur liabilities on behalf of the company.104 The statute states that the majority in interest will make the decision to take “any action required or permitted” unless otherwise provided in the articles or operating agreement.105 Rule by the majority in interest should not be taken too literally. Even if the members have not entered into a written operating agreement, they are likely to have mutual understandings about the basic business of the LLC which will constitute an oral operating agreement. Any changes in that agreement will require unanimous consent unless the operating agreement

\[\text{\footnotesize Notes and Citations}\]

itself contains a different method for amending it.\textsuperscript{106} Therefore, major decisions require unanimity. For instance, three persons form an LLC with an oral understanding that they will operate a flower shop. Two of the members, over the objection of the third, then decide that the LLC will also sell vegetables. The agreement to sell flowers was an operating agreement which could not be changed except by unanimous consent. This is similar to the result reached under partnership law which states that the partners decide ordinary matters by majority vote, "but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners."\textsuperscript{107}

The LLC default rules go one step further, however, which throws this analysis into disarray. The articles can be amended by a majority in interest,\textsuperscript{108} and the articles control if there are inconsistencies between the articles and an operating agreement.\textsuperscript{109} Which rule prevails? Unanimous consent to amend the operating agreement or majority consent to amend the articles? Does the majority interest have the power to amend the articles, even if they thereby breach their agreement with the other members?

The default rule should be simple and clear. In the absence of an agreement, unanimous consent should be required to amend either the articles or the operating agreement. Thus, the initial expectations of the parties will prevail even though the unanimous consent provision may make it more difficult to change the agreement when future circumstances require the LLC to adapt.

B. Voting

The members vote in proportion to their contribution to the LLC, as adjusted for additional contributions or withdrawals, unless otherwise provided in the articles or an operating agreement.\textsuperscript{110} The necessity of keeping an accurate capital account is addressed in the section on dis-

\begin{itemize}
\item \textsuperscript{106} W. VA. CODE § 31-1A-19 (1993).
\item \textsuperscript{107} W. VA. CODE § 47-8A-18(h) (1993).
\item \textsuperscript{108} W. VA. CODE § 31-1A-11(c) (1993).
\item \textsuperscript{109} W. VA. CODE § 31-1A-19(a) (1993).
\item \textsuperscript{110} W. VA. CODE § 31-1A-18(b) (1993).
\end{itemize}
tributions.111 Obviously, for voting purposes, too, the capital accounts should be kept stable. The members who hold the majority in capital interests will, under the default rules, determine every decision, including the election of all of the managers. Those members can also remove one or all of the managers with or without cause.112 In West Virginia corporations, shareholders can cumulate their votes so that minority shareholders can elect at least one director to the board.113 Members may be surprised at the absolute control the majority in interest can exercise in an LLC. This should not be a problem so long as this control meets the parties’ expectations when forming the LLC. But most persons forming a business as “partners” expect to have an equal voice. If five persons formed an LLC, but one contributed a majority of the capital, the other four may not be prepared for the one’s absolute control in the case of disagreement.

C. Managers

Members may elect one or more managers to operate the LLC. The members may delegate full or partial responsibility to the managers. Managers can contract debts and incur obligations on behalf of the LLC. Managers can be removed with or without cause by the members. If there are more than one manager, they act by majority vote unless otherwise provided.

D. Rights and Liabilities

West Virginia has incorporated a unique provision into its Act, stating that members have the “same rights and liabilities” as shareholders, and managers have the “same rights and liabilities” as directors.114 The implications of that short provision are enormous. It is as

111. See infra text accompanying notes 127-137.
113. Shareholders’ right to cumulative voting in West Virginia is in the constitution. W. VA. CONST. art. XI, § 2. Because the legislature gave members the “same” rights as shareholders, do the constitutional provisions override the straight voting rules contained in the Act? See infra discussion of members’ rights in text accompanying notes 139-154.
if the entire corporation code with all its case law, nuances, ambiguities, and contradictions has been dumped into the LLC act. Members, managers, and their lawyers are left with a great deal of uncertainty.

First, consider the effect of the language on the limited liability of members. For instance, will the same criteria for piercing the corporate veil be used to pierce the limited liability veil of the LLC to impose unlimited liability on the members? The factors such as shareholder control and lack of corporate formalities which are used in corporation cases to pierce the corporate veil are exactly the kind of informal organization norm contemplated by the LLC Act. Does that make limited liability ephemeral under the WVLLC Act? After all, the Act makes no other statement limiting the liability of the members. One has to refer to the limited liability of shareholders. The members’ limited liability is changed in significant ways in other parts of the Act, which will be discussed in the following section.

Do managers have all the duties of a director and the liabilities that go with those duties? First, consider the director’s duty of care in managing the corporations. The manager too has a duty of care.

In carrying out her responsibilities, the manager must exercise “good faith business judgment” under the WVLLC Act. In exercising her judgement, she is entitled to rely on information, opinions, reports or statements, including financial statements, prepared or presented by other managers, employees, legal counsel, or public accountants. The provision stating these general standards of conduct for managers is identical to the one contained in the Virginia statute.

The Virginia Act, however, contains a provision limiting managers’ liability in a breach of duty of care that is not included in the WVLLC Act. First, the Virginia Act contains a general limitation on managers’ liability to the LLC in the amount of the greater of

117. Id. The West Virginia provision allows managers to rely on these standards, but is silent with respect to whether members can rely on these standards when they are exercising management responsibilities.
$100,000 or the amount of cash received in the twelve months preceding the act or omission for which liability was imposed. Further, Virginia's provision permits the articles or operating agreement to eliminate or limit further the liability of members or managers.\textsuperscript{119}

What are the criteria in deciding issues of duty when managers have been delegated only limited responsibility? Can managers be indemnified or have their liability to the LLC limited and, if so, to what extent? Can practitioners rely on the indemnification provisions in the West Virginia corporation code? Can managers transact business with the LLC as provided in the LLC Act,\textsuperscript{120} or are they required to go through the "cleansing provisions" of the corporation act,\textsuperscript{121} which require a director who has a financial interest in a transaction with the corporation to have the transaction approved by a disinterested board or a disinterested majority of the shares, or, if not done, the director must prove the entire fairness of the transaction?

Will all this uncertainty require counsel who represent managers or member-managers to advise their clients to form an LLC in Virginia where liability (except for willful misconduct or a knowing violation of criminal law) can be limited or eliminated?

The rule concerning the rights and liabilities of members and managers appears to be immutable because there is no authority to change it in the operating agreement or articles. This statute presents several dilemmas to those who wish to form a WVLLC. Can they rely on this statute to provide members with limited liability? Does this provision determine the rights and liabilities among the members themselves in the sense that members owe to each other only the restricted duties majority shareholders owe to minority shareholders? Are members relieved then of the fiduciary duty that partners owe each other? Do managers have the same fiduciary duties and liabilities as directors in addition to the members responsibilities stated in the Act?

120. W. VA. CODE § 31-1A-22 (1993). Members and managers can lend money and transact business with the LLC and have the same rights and obligations as any other creditor.
VI. MEMBERS’ CONTRIBUTIONS AND DISTRIBUTIONS

Flexibility in planning the members’ respective financial interests in the LLC offers the most important reason, in addition to limited liability, for persons to choose an LLC as an entity in which to conduct business.\textsuperscript{122} The WVLLC Act enables members to write their own contract with respect to the form of contributions the members make, when distributions are to be made, and in what proportions the distributions will be shared among the members.\textsuperscript{123}

This flexibility is limited only by the planners’ imagination and the constraints imposed by the tax code that special allocations must have substantial economic effect—\textit{i.e.}, the tax consequences of the plan must be borne by those who receive the economic benefits and burdens of the tax provisions.\textsuperscript{124} In the absence of an agreement, the Act provides default rules.

Unfortunately, some of the financial default rules written for the Act do not offer the clarity needed by those who may want to form a hand-shake LLC to start their business. The ambiguity of these rules forces almost everyone to pay the transaction costs of having an operating agreement written. In this respect, the Act may not be as cost efficient as forming a corporation or a partnership in West Virginia.

This section begins with the Act’s prescription of the kinds of property rights, or other forms of contributions, members can make to the capital of the LLC. Next, the default rules governing the form and timing of the LLC’s distributions to its members will be discussed. Then the focus will shift to the problems in the default rules that govern the allocation of the distributions among the members. The following section will consider the financial conditions under which the LLC may legally make distributions to its members.

\begin{itemize}
\item 123. \textit{W. VA. CODE} §§ 31-1A-23 to -25 (1993).
\end{itemize}
A. Forms of Contributions

Members' contributions to the capital of the LLC may be in the form of cash, property, services rendered, promissory notes or a written promise to contribute to the LLC, cash, property, or future services. The Act offers more flexibility for making contributions to capital than does the WVBCA, which prohibits payment for shares by a subscriber's promissory note or future services.

B. Form and Timing of Distributions

Members may agree as to when interim distributions are to be made (limited only by insolvency tests to protect creditors), how the distributions are to be shared, and whether the distributions are in the form of cash or other LLC assets. Agreements on the method of sharing and the form of distributions must be in writing, otherwise the default rule of sharing distributions in proportion to capital contributions will control.

In the absence of an agreement, members are not entitled to receive distributions in any form other than cash and not before the dissolution and winding up of the affairs of the LLC. These default rules are consistent with the West Virginia's Uniform Partnership Act which provides comparable rules.

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125. W. VA. CODE § 31-1A-23(a) (1993). Like partners in partnership, LLC members who contribute services, rather than cash or property, recognize ordinary income immediately; the income is equal to the value of a capital interest. This is true unless the membership is contingent on performance or is subject to the risk of forfeiture, in which case the income is recognized upon completion of the performance. When income from compensation is recognized before payment is received, the early recognition leads to undesirable tax consequences which generally discourage LLC members from contributing services instead of cash. See I.R.C. § 61 (Supp. 1993); Treas. Reg. § 1.721-1(b)(1) (as amended in 1965); I.R.C. § 83 (Supp. 1993); Treas. Reg. § 1.83-1(a) (1973) (all dealing with the immediate recognition of income for contribution of services); Keatinge et al., supra note 2, at 432.


128. Id.

C. Allocation of Profits and Losses and Sharing of Distributions

Again, members may agree, in writing, as to how profits and losses are to be allocated and how distributions are to be shared. The flexibility of deciding how to divide distributions and to allocate profits and losses offers the most frequent reason for choosing the LLC form over the S Chapter corporation.

For example, the LLC operating agreement could allocate all the losses to one member, or all the distributions to another until she received an amount equal to her contributions, as long as each of the allocations had "substantial economic effect."13 Business planners basically must trade off the members' need for the benefits of the LLC's allocation flexibility against the inconvenience and other problems that may arise when a death or some other event causes an unexpected dissolution of the entity.

Unfortunately, if the members fail to enter into a written agreement, the default rules under the LLC for these important financial provisions are confusing and raise more questions than they answer. The statute provides that profits and losses will be allocated and distributions will be made among the members "on the basis of the value as stated in the limited liability company records, of the contributions made by each member as adjusted from time to time to reflect any additional contributions or withdrawals."131

The statute offers no guidance as to how this language should be construed. The language itself is ambiguous. Even in a simple business, the relative "value" of each member's interest for purposes of allocations and distributions of cash can be obscured by subsequent events.

For instance, assume two persons form an LLC and start off with equal contributions of cash. One member has a personal financial need, and with the consent of the other member, withdraws more than his share of the profits. Has he reduced his capital contribution by a withdrawal or has the LLC made a loan to him?

The other member leaves in the LLC her share of earnings to bolster the firm’s balance sheet. Has she made an additional contribution to capital in the form of her undrawn share of earnings or has she loaned that amount to the LLC?

The members cannot rely on the accounting treatment of these transactions because each transaction could either be accounted for as a capital adjustment or a loan. The characterization of the transactions will depend on the understanding of the members, which should be set forth in a written operating agreement. Those persons who form a “hand-shake” LLC are left with an inadequate statutory rule to resolve conflicts or solve problems.132 Does “value” of property contributed mean the value of property contributed net of the amount of any liability associated with the property? For example, one owner transfers property subject to a mortgage. Does the result change if the LLC assumes the mortgage obligation? How does one determine that a “withdrawal” is a capital withdrawal as opposed to a distribution of profits or a loan from the LLC? When do undistributed profits become additional capital?

These questions will usually arise when the members have had a misunderstanding, which is not the best time to attempt to clarify the words. The members’ primary motivation in forming an LLC may be frustrated unless they incur the transaction costs of drafting a detailed operating agreement.

The LLC default rule with respect to allocations and distributions can be remedied by drafting a statute that reflects both an understanding of the requirements of partnership tax law and the economic choices that most persons would make in forming an uncomplicated LLC. Certain provisions of partnership tax law require a determination of a

132. Members also vote for managers in proportion to their contributions “as adjusted from time to time to reflect any additional contributions or withdrawals.” W. Va. Code § 31-1A-18(b) (1993). Determination of the members’ respective interests could be important in a contest for control of management, although presumably an LLC with such a complicated structure would also have its own operating agreement which adequately addressed the accounting issues.
partner's capital interest,\textsuperscript{133} or in this case, a member's capital interest in the LLC.

The members' capital interests should remain defined and relatively fixed for at least three reasons. First, persons going into business with each other usually share an expectation that their capital is to remain in the business until the venture has been completed, much like capital stock in a corporation. Second, the difficulty in determining capital interests usually results from informal practices in withdrawing money as needed, especially in small businesses. Third, even after a member has rightfully received all or part of her capital, the member is still liable to the LLC for an amount not in excess of the withdrawn capital necessary for the LLC to pay all liabilities and claims which arose before the return of the capital.\textsuperscript{134} For these reasons, determining the amount of members' capital in the LLC at any given time may be important.

To correct the deficiencies in the current law, the LLC could be required to keep a capital account for each member and to account for the member's capital contributions and capital withdrawals separately from cash distributions and allocations of profits and losses.\textsuperscript{135} Since proportional sharing of profits and losses based on contributions appears to be what the current statute is attempting to achieve,\textsuperscript{136} the

\textsuperscript{133} See, e.g., I.R.S. §§ 704, 707, 708, 743 (1993).
\textsuperscript{134} W. VA. CODE § 31-1A-32(d) (1993).
\textsuperscript{135} Virginia's LLC Act achieves a similar result in a different way. Virginia requires each LLC to keep information and records, which includes information as to the amount of capital contributed, when additional contributions, if any, are to be made, and when the members are entitled to the return of all or part of their contributions. VA. CODE ANN. § 13.1-1028 (Michie 1992). Profits and losses are allocated and distributions are made on the basis of value as stated in those records. VA. CODE ANN. §§ 13.1-1029, -1030 (Michie 1992). These provisions appear to have been taken from the RULPA. See MODEL R.U.L.P.A. §§ 105, 503, 504. The requirement to keep information and records can be helpful to the members. Courts, however, in deciding to pierce the limited liability veil of LLCs, may use the failure to keep these records in the same way courts point to the failure of a corporation to maintain its formal records. See, e.g., Laya v. Erin Homes, Inc., 352 S.E.2d 93 (W. Va. 1986).

\textsuperscript{136} Of course proportional sharing of profits and losses in accordance with capital contributions does not address the situation of a LLC formed with one person contributing most of the capital and the other contributing most, if not all, of the services. The service member would not receive his fair share of the profits. The UPA, and the RUPA, contain de-
members' interests in profits and losses would then be in the proportion that a member’s capital account bears to all capital accounts.

Each member would also have a drawing account to which cash distributions and losses would be charged and to which profits would be credited. A credit balance would constitute a liability from the LLC to the member, and a debit balance would constitute a member’s obligation to the LLC. Credits or debits could be proportionately transferred to the capital accounts by majority voting power.¹³⁷

This rule would, of course, continue to be a default rule which would operate only if the parties had failed to enter into a written operating agreement. Even the most simple West Virginia LLC now needs a written operating agreement to address these issues because the current statutory language inadequately addresses the needs of those persons who rely on the Act’s default rules.

VII. THE ACT’S ALTERATION OF THE CONCEPT OF LIMITED LIABILITY

The Act’s financial provisions dealing with the LLC members’ relationships to third party creditors cannot be altered by an agreement fault provisions in which profits are shared equally and the parties share losses in proportion to their share of profits. This default provision, first written in the 1914 version of the UPA, assumes that the parties’ preferences are to be equal partners in the venture even though they may each contribute different amounts of capital. The assumption appears to continue to be valid today for those who want to operate informal entities, to whom the default rules are addressed. West Virginia’s Partnership Act and Limited Partnership Act provide for sharing profits equally.

Thought should be given to whether the same default rules of equal sharing of profits should also be written for LLCs. West Virginia’s current default rule assumes members want to share in proportion to contributed capital. Entities that share profits in proportion to capital contributions are generally capital intensive, such as real estate ventures, and those entities are more likely not to rely on default rules because of their greater need to have written operating agreements. The default rule should reflect most persons’ usual business expectations of equal sharing of profits unless they otherwise agree.

¹³⁷ However, if the partners make special allocations of losses and gains, the partners’ capital accounts are required to be properly maintained to account for the allocations if the allocations are to be respected for federal income tax purposes. Treas. Reg. § 1.704-1(b)(2)(ii)(b) (1993).
among members.\textsuperscript{138} This is not surprising. To the extent the statutory rules protect both the expectations of creditors and members, the LLC and its members do not incur the transaction costs of reducing to writing all the provisions the LLC would negotiate with each creditor before the creditor would be willing to extend credit to the LLC.

The WVLLC Act offers much more protection to creditors than comparable provisions contained in other LLC acts, such as Virginia's and Delaware's. The Act also gives creditors more rights against LLC members than creditors have when dealing with shareholders of closely-held West Virginia corporations. The question here is whether the LLC provisions are too open-ended in favor of creditors who could otherwise be expected to protect themselves.

A. Members’ Limited Liability in General

The Virginia LLC Act grants limited liability to its members in a straightforward fashion:

. . . . [N]o member, manager or other agent of a limited liability company shall have any personal obligations or any liabilities of a limited liability company, whether such liabilities arise in contract, tort or otherwise, solely by reason of being a member, manager or agent of a limited liability company.\(^{139}\)

In contrast, the WVLLC Act grants limited liability to its members indirectly by referring to West Virginia’s Corporation Act:

The members of a limited liability company shall have the same rights and liabilities as shareholders of corporations organized or registered under Article I [W. Va. Code §§ 31-1-1 et seq.] of this chapter, and such managers shall have the same rights and liabilities as directors of corporations so organized or registered.\(^{140}\)

The West Virginia Act therefore grants to members the same rights and imposes the same liabilities as shareholders in a West Virginia corporation. Presumably, those rights include the constitutional right that shareholders “shall be liable for the indebtedness of such corporations to the amount of their stocks subscribed and unpaid, and no more.”\(^{141}\) Shareholders’ constitutional right to limited liability is reiterated in the West Virginia Corporation Act: “A holder of or subscriber to shares of a corporation shall be under no obligation to the corporation or its creditors with respect to such shares other than the obligation to pay to the corporation the full consideration for which such shares were issued or to be issued.”\(^{142}\)

As explained below, other provisions of the WVLLC Act significantly curtail the apparent grant of member limited liability. For example, members are treated less favorably than shareholders in the re-

\(^{141}\) W. Va. Const. art. XI, § 2.
requirement to return wrongfully made distributions even if the member did not know he received a distribution at a time the corporation was insolvent. Even when the member rightfully received the return of his capital distribution, he is required to return it when necessary to pay all claims arising before the return of the capital. And the member holds all these distributions as a trustee, so the creditor is presumably entitled to a constructive trust on traceable funds. No similar provision applies to shareholders who are responsible for the return of distributions only if they knowingly received a wrongful distribution. If the legislature intended to equate members with shareholders, then some of these LLC provisions are unconstitutional.

B. Members' vs. Shareholders' Limited Liability

Under West Virginia's Corporation Act, directors are liable to the corporation for authorizing it to make distributions or pay dividends at a time when the corporation is insolvent or when the distribution or payment would cause the corporation to become insolvent. 143 "Insolvent" in this context means the "inability of a corporation to pay its debts as they become due in the usual course of its business" (insolvency in the equity sense). 144 The reason for applying this test is that the creditors' claims for payment take priority over the shareholders' rights to receive a distribution. If the affect of the distribution would cause the corporation not to be able to pay its creditors as usual, the directors who made the decision to declare a dividend will be held liable to the corporation. If directors violate this insolvency rule, they are jointly and severally liable to the corporation for any excess in the amount of the dividend or distribution over the amount which could

143. W. VA. CODE §§ 31-1-102, -100 (1993). Directors are also required to make distributions and dividend payments from certain legal capital sources. W. VA. CODE § 31-1-99, -100 (1993). However, these legal capital rules can be manipulated, and essentially they are meaningless because they only represent accounting line entries. The RMBCA has eliminated the legal capital sources and uses only the two insolvency tests which are almost identical to tests used in the West Virginia LLC Act. Compare R.M.B.C.A. § 6.40 with W. VA. CODE § 31-1A-29(a) (1993).

have been legally paid or distributed. Directors are not liable for the amounts if they can prove that they acted in good faith in relying upon financial statements of the corporation which an officer or an independent public accountant represented to be correct. Directors have to make a judgment that the corporation will continue to operate in the foreseeable future in the way it is presently operating and that the expected receipts will be enough to pay the expected debts as they become due. There is no bright line test. Subsequent events may render the corporation insolvent, but directors are entitled to a good faith defense.

Under the West Virginia Corporation Act, directors are entitled to contribution from only those shareholders who accepted or received a distribution or dividend knowing the dividends or distributions were made in violation of the rules. The shareholders themselves are not liable directly to the corporation or to the creditors. Directors are liable only for the excess of the amount of the distribution not legally permitted, and only those shareholders who knew they wrongfully received a distribution are required to make contribution to the directors.

Under the WVLLC Act, the LLC cannot make a distribution if the effect of the distribution would render the LLC insolvent either under an equity insolvency test or the balance sheet (sometimes called a "bankruptcy") insolvency test—the total assets cannot be less than the total liabilities. The LLC, in making the determination to make a distribution, is entitled to rely (the statute does not state that members or managers may rely) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or a fair valuation or other method that is reasonable in the circumstances. The LLC would appear to have a defense that it relied on reasonable financial statements or valuations in making a determination of whether it complied with the insolvency tests. The statute unfortunately does not specifically state that good faith reliance on those

146. Id.
147. W. VA. CODE § 31-1-102(c) (1993).
statements constitutes a defense, which statement is made explicit in the corporation code. If one member or manager knew facts that made the reliance on the financial statements unreasonable, would that knowledge be attributed to the LLC so the LLC and other members were deprived of a defense? In any event, accurate record keeping is essential, particularly considering the remedies for violating the insolvency tests.

If distributions are made in violation of the insolvency tests, the members are liable to the LLC for a four-year period for the amount of the distribution wrongfully received. 149 The effect of these provisions is to subject members and managers of an LLC to a more expanded liability than the limited liability of directors and shareholders of a corporation. Managers are not held specifically liable for the return of the distributions under the Act, but manager liability could attach indirectly because managers have the “same rights and liabilities” 150 as directors, and those liabilities presumably include the breach of duty of care in making a decision to authorize a wrongful distribution.

The LLC provision to return the wrongful distribution makes sense in an LLC managed by its members who are active participants in decision-making rather than passive investors. If the active members make a distribution in reliance on financial statements that they should know are unreliable and then receive those distributions in violation of the insolvency tests, they should return the distributions—at least the amount in excess of the legal distribution. 151

Shareholders who actively participate in a closely-held corporation in their roles as directors and officers, as well as shareholders, would be liable as directors for the excess of those distributions made in

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149. The corporation code holds the director liable for the “excess of the amount of such dividend or distribution which could have been paid or distributed without violation . . . .” W. VA. CODE § 31-1-102(a) (1933), while the LLC provision states that a member is liable “for the amount of the distribution wrongfully made.” W. VA. CODE § 31-1A-30 (1993). The LLC’s imprecise wording could be interpreted to require the member to return all of the distribution, not just the excess.

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violation of the equity insolvency tests. Corporation law contemplates, however, that management and ownership may be separated and therefore does not penalize the passive shareholder who had no part in making the distribution decision.

Even though the WVLLC Act contemplates centralized management through managers, the Act’s regulatory scheme does not provide equivalent protection for the innocent passive investor. All members are equally liable for the return of the wrongful distribution. As a policy matter, the legislature could have decided to protect all creditors to the extent of all profits erroneously paid out even to innocent members. If the legislature meant this result, other provisions of the statute erroneously and misleadingly state that members have the same rights and liabilities as shareholders.

"Distribution" is defined as “a direct or indirect transfer of money or other property, or incurrence of indebtedness by a limited liability company, to or for the benefit of its members in respect of their interest in such company.” The insolvency tests are thus important when a member transfers property to an LLC, as well as when a member receives a distribution from an LLC. If, for instance, a member transfers to the LLC property subject to a mortgage, and the LLC assumes the mortgage, that assumption of the mortgage would constitute a “distribution” to which the insolvency tests would also be applied at the time of the transfer. The property’s fair market value would have to exceed the mortgage liability to avoid charging the member with having received a distribution.

C. Members’ Liabilities as Trustees

Like shareholders’ obligations to pay for their shares, members are liable to the LLC for any contributions to capital they have agreed in writing to make. Unlike shareholders, all members are required to

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152. This result could give a windfall to those creditors who did not rely on the previously paid distributions at the time credit was extended, but nevertheless benefitted because distributions had been made on the basis of subsequently judged erroneous insolvency tests.
154. Id.
return to the LLC any distributions received by members at a time when the LLC failed to meet the insolvency tests. In addition to these liabilities, however, additional liabilities that present serious problems are imposed on members. First, the WVLLC Act requires members to hold as trustee for the LLC: “(1) property which is stated in the articles of organization as having been contributed by the member but was not contributed or was wrongfully or erroneously returned; and (2) money or other property wrongfully paid or conveyed to the member on account of the member’s contribution.”\textsuperscript{155}

Section One of the provision could be interpreted to mean that the member would hold as trustee for the benefit of the LLC’s creditors specific property which is stated in the articles of organization. This section seems easy to avoid because the articles of organization are not required to state what property members have contributed to the LLC. If a creditor can require the specific property to be included in the articles, the creditor presumably has the power to require the LLC and its members to give other written promises and/or security interests which will provide the creditor more specific protection than this provision.

Section Two of this provision requires the member to hold as trustee for the LLC money or other property wrongfully paid or conveyed to a member “on account of his or its contribution.”\textsuperscript{156} Again, this provision is apparently intended to protect creditors. If a member, in preference to other members, received money or other property from the LLC in violation of a sharing agreement in an operating agreement, or in violation of the proportionate distribution rule, the money or property erroneously paid or wrongfully appropriated to that member would not be a payment made “on account of the member’s contribution.” Therefore, the provision does not appear to be aimed at requiring a member to return wrongfully received money to a LLC for the benefit of the entity or the other members. It probably is referring to money wrongfully distributed in violation of the insolvency tests.

\textsuperscript{155} W. VA. CODE § 31-1A-32(b) (1993).
\textsuperscript{156} W. VA. CODE § 31-1A-32(b)(2) (1993).
Another statute requires the members to repay a wrongful distribution within a four-year period. Does this mean the members hold all wrongful distributions as trustees? For whose benefit? The insolvency tests are for the benefit of creditors. If a member is supposed to hold wrongful distributions as a trustee, that requirement should have been placed in the section requiring the member to return the wrongful distribution to the LLC.

The legislative intent of this provision is unclear. Is the provision designed to impose a trustee's duty on a member in her relationship to the LLC, to impose a trustee's duty on the member for the benefit of creditors, or to impose both duties?

The only business entity provision that uses the word “trustee” in this context is contained in general partnership law which holds a partner accountable as a trustee for any profits derived by the partner without the consent of the other partners.157 This partnership section holds a partner accountable as a fiduciary to the partnership for the benefit of the other partners.158 No other statutes require an owner of a business entity to act as a “trustee” for the benefit of the entity’s creditors, just as a sole proprietor does not act as a “trustee” for her creditors.

If this provision is attempting to require, under certain conditions, members to act as trustees for the benefit of the LLC’s creditors, the provision constitutes an unusual and extraordinary duty to which more than one kind of liability attaches. Not only would a member be liable in damages to a creditor under this provision for the amounts received, but a constructive trust could be placed on any traceable property. The member would also be liable, in tort, to a creditor for the member’s breach of trust.159 The high standards to which a trustee is held are a

159. See BROMBERG, supra note 158, at §§ 6:93-6:94 and the cases cited therein. The characterization of a partner acting as trustee for the partnership is that a constructive trust can be more easily imposed on the partner's property that was obtained by usurpation of partnership opportunity or other wrongful acts. In addition to damages, the partner can be liable for punitive damages. Assuming funds could be traced, the partner's subsequent transactions can be enjoined or set aside.
significant departure from the usual relationship between an owner of an entity and the creditors of that entity.

This provision could also be construed to give added protection to creditors if members received distributions when the LLC could not meet the insolvency tests and to protect creditors who were not paid in the process of winding up the LLC. In other words, upon the dissolution and winding up of an LLC, money or property paid or conveyed to members at a time when creditors had not been paid would be deemed to be held by the members in trust for the LLC to pay those creditors.

This conclusion is supported by another provision of the Act. Upon dissolution and after a certificate of dissolution has been issued:

The manager or managers in office at the time of dissolution, or the survivors of them, or, if none, the members shall thereafter be trustees for the members and creditors of the dissolved limited liability company and as such shall have authority to distribute any company property after dissolution, convey real estate and take such other action as may be necessary on behalf of and in the name of such dissolved limited liability company. 160

Here, the intent to make trustees of the manager or members for the benefit of the creditors is made explicit. These provisions raise serious problems because: (1) the term “creditors” has been broadly construed in West Virginia; 161 and (2) no limitation period, other than the generally applicable ones, cuts off these claims. Even after the LLC properly winds up its affairs and makes distributions to all known creditors, the members are still exposed to claims of unknown creditors whose claims arose before the LLC’s dissolution.


161. In holding that a corporation did not give notice of its intent to dissolve to all of its creditors, the West Virginia Supreme Court broadly defined the term “creditor” to include “the owner of any right or action against another, whether a claim or legal right or damages arising out of contract or tort.” Alpine Property Owners Assoc., Inc. v. Mountaintop Dev. Co., 365 S.E.2d 57, 64 (W. Va. 1987).
In contrast, under corporation law, a dissolving corporation files an intent to dissolve with the secretary of state and gives notice to all of the corporation's known creditors. After paying or adequately providing for the payment of all the corporation's obligations, the corporation distributes the remainder of its assets to the shareholders. The corporation then files articles of dissolution, and the secretary of state issues a certificate of dissolution. Once the secretary of state has issued a certificate of dissolution, and provided that all known creditors have been noticed, all creditors have a two-year limitation period within which to file a claim against the corporation. Creditors unknown to the corporation at the time of dissolution are still bound by this two-year period of limitation. If the directors have distributed assets to the shareholders without paying all known obligations, the directors are jointly and severally liable to the corporation for the value of the assets to the extent that the corporation's obligations were not paid. The directors are entitled to contribution, in proportion to the amounts received, from those shareholders who received the assets knowing the distribution was made in violation of the statute.

Under West Virginia's Limited Partnership Act, a partner who has rightfully received the return of her contribution is liable to the limited partnership for the amount of the contribution for a one-year period to the extent necessary to pay creditors who extended credit to the limited partnership during the period the contribution was held by the partnership.

Upon completion of the winding up, the LLC files a certificate of cancellation with the secretary of state. The act of filing the certificate of cancellation does not begin the running of a limitations period on creditors' actions against the LLC. LLC members, in contrast to shareholders and limited partners, continue to be exposed to the risk of liability for unasserted claims arising before dissolution, and the mem-

166. W. VA. CODE § 31-1-102(c) (1993).
bers hold money or property distributed by the LLC in trust for the benefit of those claimants.

Another provision states that even when a "contributor"\(^{169}\) has rightfully received a return of all or part of her capital contribution, the contributor is nevertheless liable to the LLC for any sum, not in excess of the return of capital, necessary to pay LLC creditors who extended credit or whose claims arose before the return of the capital.

If a member received a distribution wrongfully (in violation of agreement or the insolvency tests), the member remains liable to the LLC for the return of the distribution for a four-year period. If the member rightfully receives the return of her contribution (is this not also a distribution?), she remains liable to the LLC to pay creditors who extended credit or whose claims arose before the return for a period that presumably is limited by other statutes, but which could be longer than four years. The rules lack internal consistency. One cannot discern which rule applies when and which rule trumps another rule. Conceivably, an LLC member could be placed in the position of arguing that she received a distribution wrongfully so she could take advantage of the four-year limitation period.

Members of West Virginia LLCs are placed in the uncertain position of not being able to know when their personal liability to LLC creditors has terminated or how much they are expected to return to the LLC. They do not know how much additional personal liability they are assuming when the statutes, with seeming casualness, denominate them trustees on behalf of creditors.

This lack of certainty and additional liability exposure is unfortunate. There is no policy justification to treat LLC members' liability differently from shareholders of closely-held corporations or limited partners in limited partnerships. The provisions serve to undermine a primary reason for members to form a LLC—limited liability.\(^{170}\)

\(^{169}\) W. Va. CODE § 31-1A-32(d) (1993). This LLC section is the only one in the Act that contains the word "contributor" which is not defined. "Contributor" may have been used to include members and assignees who are not members unless all members consent to the assignees becoming members.

\(^{170}\) Whether owners of closely-held businesses should ever be allowed to limit their liability as a matter of policy is beyond the scope of this article. But if the legislature has
Sophisticated business persons will be motivated by these uncertainties and possible exposures to unnecessary liability to form their LLC in another jurisdiction (e.g., Virginia) and register to do business in West Virginia as a foreign LLC. They can thus avoid these ambiguous provisions. Moreover, lawyers who fail to advise their clients of these uncertainties and exposures, and the differences among the statutes, risk committing malpractice.

These provisions, unique to the WVLLC Act, are unnecessary from a creditor’s rights point of view. Creditors can (and usually do) require members to guarantee personally or to become co-obligors on loans to an LLC. Members should be able to rely on insurance to pay tort claimants without exposing themselves to additional and unforeseen liability. The Act gives creditors unexpected leverage to extract payments from LLC members because of the LLC’s necessity to prove that it met insolvency tests each time distributions were made (even after the four-year limit) and because of the members’ additional obligations to act as trustees for creditors to return distributions to the LLC upon unspecified and vague conditions.

These consequences are “unexpected” because the West Virginia statute states up front that members and managers have the “same” rights and liabilities as shareholders and directors of a corporation. Specific provisions in the statute then proceed to alter this concept in subtle but significant ways. What purpose is served in providing West Virginians with less favorable consequences than they can achieve by incorporating (with its less favorable tax treatment) or by forming an LLC under the laws of a jurisdiction which does not contain these ambiguities and limitations?

determined that some forms of closely-held businesses can enjoy limited liability, there is no policy justification to treat one form of business more or less favorably than another.
VIII. APPLICATION OF OTHER LAWS

A. Securities Law

In forming a West Virginia LLC, business planners should be aware of the potential importance of whether an LLC interest will be classified as a security for purposes of state and federal securities laws. 171

Promoters have been quick to use LLCs to attract investments. Recent reports state that promoters are selling ownership interests in “wireless cable” and related computer technology by packaging the investment in an LLC and then selling interests in the LLC to the public. State securities regulators in sixteen states have already filed legal actions against a variety of persons, seeking to close down their sales operations on the grounds that the sale of the ownership-interests in LLCs is the sale of a security in violation of the registration requirements of state and federal law. 172

A membership interest in an LLC is not expressly defined as a “security” under any state or the federal securities laws. However, an interest in an LLC could be an “investment contract” within the statutory definition of a security. As defined by the Supreme Court, an investment contract “means a transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party.” 173 Focusing on the third part of the test, courts have generally held that general partnership interests are not securities because the general partners themselves can exercise the power to manage the business; and therefore

171. For comprehensive examinations of this issue, see Mark A. Sargent, Are Limited Liability Company Interests Securities?, 19 PEPP. L. REV. 1069 (1992); Carol R. Goforth, Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage This Result, 45 HASTINGS L.J. (forthcoming 1994).
the profits are not derived "solely from the efforts of others." On the other hand, limited partnership interests are almost uniformly held to constitute securities because the power to manage is held by the general partner, while the limited partners have no right to exercise any control over the business. The profits in a limited partnership are derived from the efforts of others.

LLCs can be structured like a general partnership with the authority remaining in the hands of all the members, or they can be structured like a limited partnership or a corporation with centralized management in which the members cannot exercise any practical power. The issue of whether the LLC interests constitute securities is likely to turn on these factual considerations. The courts should begin clarifying some of these issues soon as the state securities regulators crack down on the promoters of LLC investments.

B. Multistate Operations

If participants form an LLC with operations in states outside of the state of formation, the LLC may be transacting business in a state that has not enacted LLC legislation. States that have not enacted LLC statutes may not respect the limited liability of the foreign LLC members. The state courts could find that the members of the LLCs were general partners for the purposes of imposing unlimited liability on them.

States may exercise reasonable control over foreign entities transacting business in the state. When a state has not adopted an LLC statute, whether that state will honor the limited liability of a foreign LLC requires consideration of principles of comity and the constitutional provisions of the Full Faith and Credit Clause and the Interstate Commerce Clause. When a state adopts an LLC statute, principles of the Interstate Commerce Clause will require the state not to discriminate against foreign LLCs.

175. Sargent, supra note 171, at 1087-90 and the cases cited therein.
176. See Keatinge et al., supra note 2, at 447-56 for an extensive discussion of interstate LLC transactions.
The issue will be moot if all states adopt LLC statutes. However, holdout states could become much more of a problem because of the presumption that the legislature decided against adopting an LLC statute on the public policy grounds of not extending limited liability to unincorporated organizations.

West Virginia’s LLC Act includes a specific statement respecting the status of foreign LLCs. Foreign LLCs may transact business in West Virginia with the understanding that the foreign state’s LLC rules will control the liability of its members.\textsuperscript{177}

IX. USE OF LLCs FOR PARTICULAR BUSINESSES

The LLC can be used successfully to form a workable structure for most closely-held businesses. Business planners should consider an LLC any time the parties need limited liability, the flexibility of flow through partnership taxation treatment, and control of management. An LLC could substitute for any business that would otherwise be organized as a general or limited partnership, or as a corporation taxed either as a C corporation or an S corporation.

Complicated factors enter into a determination of whether an LLC is the best form in any particular situation. Those factors include each participant’s tax\textsuperscript{178} and other individual issues, and the particular needs for the business itself. For instance, a business in which the most valuable asset is intellectual property may not be suited for an LLC which can easily dissolve. One of the difficult issues in transferring intellectual property rights is establishing a good chain of title.

\textsuperscript{177} W. VA. CODE § 31-1A-48 (1993).

\textsuperscript{178} Under the Omnibus Budget Reconciliation Act of 1993, individual tax rates, for the first time since 1986, can exceed corporate rates. The 1993 Act increases marginal tax rates for married individuals filing jointly to 36% on taxable income exceeding $140,000 and 39.6% of taxable income exceeding $250,000. The maximum rate after the phase-out of itemized deductions and personal exemptions is approximately 41%. Corporate income of less than $10,000,000 continues to be taxed, generally at 34%. In addition, if a C corporation meets the tests of a “qualified small business” (aggregate gross assets not exceeding $50 million), shareholders who have owned the stock more than five years can exclude 50% of their gain on the sale of the stock. The effect of these tax rates may need to be considered in determining if flow-through taxation of the LLC is in an individual’s best interest.
This issue can be more easily addressed by retaining the intellectual property in a corporation that possesses continuity of life. The corporation can then license the intellectual property to the business formed as an LLC to exploit the use of the property.

Certain types of businesses may be particularly good candidates for an LLC form. For example, venture capital firms, joint ventures, businesses with international participants, and professional service firms have characteristic structural issues that may be addressed by using an LLC.

A. Venture Capital Firms

Venture capital firms are typically formed as limited partnerships by a group who pools its capital to fund the start-up of businesses or to fund a business still in a developmental stage. The firm itself is managed by professionals, experienced in investing and managing new businesses. The participants may need complex distribution provisions because of the varying amounts each participant contributes and the timing of when distributions are made. The participants also want to exercise some supervision over management, which is denied them as limited partners if the firm were organized as a limited partnership. The corporate form may not provide sufficient tax, financial, or shareholder-control flexibility. For example, an S corporation is usually not available because there are too many shareholders or the shareholders are not individuals. The LLC operating agreement can be tailored to the participants’ needs with less cost than in constructing agreements within the more rigid corporate framework.

B. International Participants

S corporations are designed to allow a small group of individuals (35 or less) to form a corporation in which the income is allocated proportionately to each individual’s contributions and that income is taxed once at the individual level. The complex federal tax rules under Subchapter S of the Code are arguably designed to limit how the S corporation can be used because use of the form decreases the amount of federal revenue otherwise obtained by taxing C corporations’ profits
at the entity level and again at the individual level. Corporations and other business entities, and non-resident aliens, are not eligible to own interests in an S corporation. An LLC offers to those ineligible participants a form in which the profits are taxed only once at the participant's level under federal partnership tax rules, which are much more flexible and less complex than Subchapter S rules.

Transnational business ventures located in the United States are now commonplace. International participants in those ventures need a business form in which they can participate with United States residents without disadvantaging any of the participants. Most of these ventures are organized as C corporations or general partnerships. Limited liability entities similar to LLCs have existed in Europe and South America for a long time, so many international participants are comfortable with the concept of the form. International transactions within West Virginia should be facilitated by the availability of a West Virginia LLC.

C. Joint Ventures

The LLC form should be considered in formation of any business in which the business is likely to experience initial losses, with a potential future sale of the business at a substantial appreciation. For instance, an individual and a C corporation could form a joint venture to develop a real estate project. The individual could enjoy a disproportionate allocation of the losses in the beginning of the business with

179. Restricting S corporations in these artificial ways for tax policy reasons (depletion of tax revenues) does not seem defensible. No limitations are placed on the identity of the participants who wish to form a partnership to be taxed under the comparatively more favorable rules of Subchapter K. Those participants can form partnerships to avoid double taxation. Until the advent of the LLC, the participants forming partnerships were penalized by being required to sacrifice limited liability for all except limited partners.

The possibility that broad acceptance of LLCs could undercut the two-tier corporate taxation system has not gone unnoticed. Congressman Rangel has announced that the Subcommittee on Select Revenue Measures will hold hearings on the taxation of limited liability companies. The announcement mentions the concern that LLCs could circumvent two-tier taxation to an unacceptable extent. Agenda for Organizational Meeting of Subcommittee of Select Revenue Measures (February 2, 1993) available on Lexis as 93 TNT 25-22.

180. Keatinge et al., supra note 2, at 378.
a different sharing arrangement of profits on the sale of the property. A tax practitioner experienced in partnership taxation law would need to plan the intricate provisions of an operating agreement to permit the members of the ventures to benefit from these disproportionate allocations.

D. Professional Service Firms

The advent of LLCs has coincided with professionals’ increasing concern about liability for negligence claims arising out of the practice of the professions.181 In many states, LLC Acts have included provisions authorizing professionals to form professional limited liability companies (PLLCs). These PLLC’s provisions often expressly limit a member’s liability for negligence claims against a co-member. Each member continues to have unlimited liability for her own malpractice.

West Virginia’s Act is silent with respect to authorizing PLLCs. West Virginia has a statute that permits professional legal corporations to incorporate pursuant to the general corporation law.182 At least for lawyers, the question of whether incorporating would serve to limit a

181. Professionals have traditionally practiced as partners, and as in any general partnership, all of the partners are jointly liable for the debts and obligations of the partnerships, including the claims arising when one partner injures a client through negligence. Professional corporations were first authorized to take advantage of more favorable tax treatment given to employees in qualified pension plans than could be obtained by partners who were not considered employees. By 1982, the tax code had been amended several times so that the disparity between employees and the self-employed had been almost eliminated. Even if the tax reasons for incorporating are no longer an impetus for incorporating, professionals can incorporate to take advantage of limited liability. Limited liability for shareholders of a professional corporation has two aspects: first, limited liability with respect to the ordinary debts and obligations, such as rent and utility bills; and second, limited liability with respect to negligence claims arising out of the practice of the profession. A professional corporation limits the liability of the shareholder for the first kind of obligation, but never limits the shareholder from her own malpractice. The question remains whether the professional’s liability is limited for a co-shareholder’s malpractice. Historically, the professional’s liability for the conduct of her partner would be unlimited because of the usual application of the partnership liability rules. This concept of unlimited liability for the co-shareholder’s negligence has been carried over in some states’ professional corporation statutes or in case law interpreting those statutes. Other states have expressly provided that co-shareholders are not personally liable for each other’s malpractice.

lawyer’s liability for the acts of her co-shareholder remains open. The language is ambiguous, and courts in other states have interpreted similar language both to impose liability and to limit liability.\textsuperscript{183} West Virginia courts have not ruled on the issue. If West Virginia lawyers and other professionals are permitted to form PLLCs, West Virginia courts are likely to disregard whether the entity is a professional corporation or a professional limited liability company in deciding the vicarious liability issue. Because of the uncertainty surrounding other aspects of the limited liability of an LLC member, professionals in West Virginia would appear to be better served in relying, for the present, on the more certain provisions of the professional corporation act.

\textbf{X. RECOMMENDATIONS FOR A SECOND GENERATION STATUTE}

The West Virginia legislature should be congratulated for recognizing the importance of limited liability companies and taking the lead in enacting one of the earlier statutes. The risk in adopting a statute quickly, of course, is that the statute will be fundamentally flawed. The most serious flaw of the WVLLC Act is that members are not treated on a parity with West Virginia shareholders or limited partners. No purpose is served in treating differently the owners who form these entities. In forming closely-held businesses in West Virginia, business

\begin{footnotesize}
\begin{enumerate}
\item[183.] W. VA. CODE § 30-2-5a (1993), authorizing legal corporations, is silent as to whether limited vicarious liability exists, and to date, there is no interpretive West Virginia case law. However, other jurisdictions with similar statutory provisions may supply some interpretive assistance. For example, Utah’s statute is similar to West Virginia’s statute. UTAH CODE ANN. § 16-11-1 (1987). In Stewart v. Coffman, 748 P.2d 579 (Utah App. 1988), the Utah court concluded that a shareholder of a law firm organized under the Utah Professional Corporation Act was not vicariously liable for the legal malpractice of another shareholder.

Wisconsin’s legal corporation statute expressly provides that liability remains unchanged among the members. Wis. STAT. § 180.1915 (1989). The Wisconsin Court of Appeals, in Anderson v. McBurney Stebnitz, 467 N.W.2d 158 (Wis. Ct. App. 1991), held that this statute treated the shareholders of the legal corporation as partners for liability purposes. Conversely, Arizona’s professional corporation statute expressly provides that “a shareholder is not vicariously responsible for the liability of another shareholder.” ARIZ. REV. STAT. ANN. § 10-905 (1993). Wisconsin and Arizona provide examples of how West Virginia’s legislative intent could have been made explicit.
\end{enumerate}
\end{footnotesize}
persons should be able to select the business form best suited to their needs, including one with favorable federal partnership taxation treatment.

By exposing the members to unexpected liabilities, the present WVLLC Act penalizes a person for choosing an LLC instead of forming a corporation or limited partnership. For example, members who have no knowledge that a distribution was made in violation of the insolvency tests are nevertheless liable for the return of the distribution. Creditors who extended credit after the wrongful distribution can rely on that statute to extract payment from those members even though the creditors had not relied on the availability of those assets when credit was extended. The innocent member is not even protected by an indemnification provision against the wrongful decision maker. No provision exists for a derivative action.

Even after a member has rightfully received the return of her capital, she is liable for an unspecified period of time to return that capital for all creditors who extended credit or whose claim arose before the return of the capital contribution. In contrast, if a corporation redeems a shareholder’s shares at a time when the corporation is solvent, the shareholder has no obligation to return the money to the corporation.

When a corporation is dissolved and all known creditors are noticed, a two-year statute of limitations cuts off creditors’ claims. Neither a specific statute of limitations nor notice of dissolution cuts off LLC’s creditors’ claims.

In situations where a member may be required to return distributions or capital contributions, the member holds such funds as a trustee and therefore is subject to constructive trusts and damages for breach of a trustees’s duties. In other words, the capital the LLC member places at risk in forming an LLC and all profits distributed to the LLC member remain at risk for creditors to pursue under the provisions of a unique statute that has never been judicially interpreted. The result is that members’ liability is not as limited when forming an LLC as when parties form corporations, limited partnerships, or foreign LLCs. This additional risk may be acceptable to those members actively participating in an LLC, but LLCs may find it more difficult to gain
access to the investment funds of passive investors who are not willing to accept these additional risks.

Other issues in the Act need to be addressed as well. They include increased flexibility for mergers between LLCs and other entities and in choosing which noncorporate characteristics members desire. The issues also include defining capital accounts and improving default dissolution rules. To address all of these issues, amending legislation could be introduced to "clean up" the Act. This type of ad hoc remedy often results in new ambiguities and uncertainties. A better approach would be to adopt a uniform limited liability company act with only those minor changes that reflect local procedural practice, such as recording articles with the county clerk and West Virginia's long-arm statute.

The fundamental governance rules that determine members' relationships and liabilities should be uniform with the other states. First, adoption of a uniform statute will allow business persons in this state to benefit from case law developed in more commercial states. West Virginia business persons will obtain the precedential benefit of these decisions in ordering their next transaction without incurring the costs of using the court system. Second, a uniform act will encourage investment in West Virginia. Considerable resources have been expended on encouraging foreign investment in West Virginia and job creation

184. The Iowa Limited Liability Company Act was enacted in 1992. IOWA CODE § 490A.100 (1993). Since the initial enactment, the Iowa Act has been amended eighteen times.

185. The National Conference of Commissioners of Uniform State Laws are in the process of drafting a Uniform Limited Liability Company Act. The October 26, 1993, draft is scheduled to be replaced by the succeeding draft in the summer of 1994.

A working committee representing varied interests could be formed to consider whether the uniform act would meet the needs of West Virginia business persons. This action has been taken before and offers a good precedent. When the West Virginia legislature adopted the American Bar Association's Model Business Corporation Act in 1974, it did so after the legislature had created a "corporation law study committee" in April 1972 to write the act. The resulting act was amended in 1975 to correct errors and reflect other changes needed in the corporation business act. See Note on Corporation Act, supra note 73, at 50.

186. We have only to look at the Uniform Partnership Act of 1914 that was adopted by every state (except Louisiana). That act has served a long and useful purpose precisely because all of the states passed the Uniform Act and because each of the states could inform themselves by the judicial interpretations of the other states.
resulting from bringing new business to the state. If an international participant or another state’s participant understands West Virginia’s uniform act, they will be more likely to use the West Virginia rules. If those same participants perceive the rules to be unique and provincial, they will simply insist that the West Virginia party agree to form a foreign LLC so that everyone can be more certain of each other’s respective rights and responsibilities.

This area of the law is grounded largely on enabling legislation to allow businesses to operate pursuant to owners’ agreements or allow owners to rely on a set of default rules that form an acceptable off-the-rack agreement when tailor-made agreements have not been reached. These statutes should be drawn with specific rules to protect parties’ usual expectations, so parties, if they choose, do not have to incur considerable transaction costs in the formation or the dissolution of a business.

To the extent that these rules are uniform, everyone should benefit from the reduced transaction costs, the reduced need for litigation, and the promotion of certainty in commercial transactions that create the wealth on which a healthy tax base depends.

West Virginia has supported the policy underlying uniformity in these areas by adopting the Uniform Partnership Act, the Revised Uniform Limited Partnership Act, and the Uniform Commercial Code. West Virginia will benefit in this area as well by adopting a uniform LLC statute.