

Publications - Limited Liability

LIMITED LIABILITY COMPANIES

Overview of the Limited Liability Acts in the State of Maryland, the District of Columbia, and the Commonwealth of Virginia

One form of contractual risk transfer is the limitation of liability which is afforded under certain forms of the organizational structure of a business organization. One feature of the Limited Liability Company (LLC), separate and apart from certain tax advantages, is the ability of the members and managers to limit their personal liability. When considering the risks involved in the ownership, operation and control of such companies, attention must be given to what loss exposures confront members and managers of the Limited Liability Company, and the extent to which contractual risk transfer can be provided for and the extent that those risks can be insured.

This publication deals with the potential liability faced by members and managers of the LLC for fiduciary liability and other risk exposures which are present, as well as insurance coverage issues either under special policies or by endorsement to Directors and Officers Liability (D&O) policies.

In view of the fact that the Limited Liability Company is a relatively recent form of business organization, it is necessary to have an understanding of the statutory provisions governing the formation of such organizations in order to understand the liability risks associated with their ownership, operation and control. Therefore, an overview of the statutory provisions of the Limited Liability Acts of Maryland, The District of Columbia and Virginia is presented.

The Maryland Limited Liability Company Act

A Limited Liability Corporation (hereinafter "LLC") is defined by The Maryland Limited Liability Company Act, Title 4A of Corporations and Associations, as a permitted form of an unincorporated business organization composing of at least one member which is organized and existing under the Act. An LLC is an unincorporated form of business organization similar to a general or limited partnership, but possessing a limited liability "shield" which protects its owners from liability to the same extent that stockholders of a corporation are insulated from its debts and

obligations. If properly structured, the LLC will be treated as a partnership for federal, and in Maryland, state income tax purposes.

The determination of whether an unincorporated entity, such as an LLC, will be categorized, for federal income tax purposes, as a partnership, or an association taxable as a corporation, turns on whether the entity possesses three or more of the following four "corporate" characteristics: (1) limited liability; (2) continuity of life; (3) centralized management; and (4) free transferability of interests. If an LLC qualifies as a partnership, it will offer both partnership tax treatment, as well as limited liability treatment to all of its owners.

The internal affairs of an LLC are governed by Maryland's Limited Liability Company Act (hereinafter "Act") unless the members agree otherwise. This agreement is known as the "operating agreement" and is analogous to a partnership or limited partnership agreement or the charter, by-laws, and shareholders' agreement of a corporation. The operating agreement is defined broadly to encompass "any agreement and the amendments thereto, of the members as to the affairs of a limited liability company and the conduct of its business." Md. Code Ann. § 4A-101(o). Unless the articles of organization specifically provide otherwise, there is no requirement that the operating agreement be in writing.

The Act establishes the terms of the parties' relationship if they have no operating agreement or the operating agreement fails to address a particular issues. These "default rules" are designed to ensure that the LLC will lack at least three of the corporate characteristics of (1) limited liability; (2) continuity of life; (3) centralized management; and (4) free transferability of interests, and thus will be categorized as a partnership for federal income tax purposes.

Limited Liability - An organization possesses the corporate characteristic of limited liability if there is no member who is personally liable for the debts of or claims against it. In accordance with Md. Ann. Code § 4A-301, no member of an LLC shall be personally liable for the obligations of the limited liability company, and therefore an LLC organized under the Act will always possess the corporate characteristic of limited liability.

Centralized Management - A corporation is generally managed by a board of directors which has broad authority to set policy and direct its operations. The directors can best be viewed as the representatives of the stockholders. The management structure is different in a general or limited partnership, where the power to set policy and direct operations is vested in the general partners or partners solely by virtue of their status as general partners. A Maryland LLC which does not modify the Act's default rules should lack centralized management because, under the Act, the LLC will be

managed by the members exclusively in their membership capacities. Moreover, under the Act, all members are deemed to have apparent authority to act as agents of the LLC in the ordinary course of its business solely by reason of their membership in the LLC. Md. Code Ann. §4A-401(a)(1). However, this authority granted by the Act may be eliminated by an appropriate statement set forth in the articles of organization, or the actual authority of a member may be modified by the terms of the operating agreement. Therefore, avoiding the characteristics of centralized management requires careful planning.

Continuity of Life - A corporation is a legal entity separate and distinct from its shareholders, and its continued existence is not dependent on events affecting its shareholders. The dissolution of a corporation is, thus, not caused by an event occurring at the shareholder level, such as the death of a shareholder. However, a partnership generally dissolves upon the dissociation (death, insanity, resignation, bankruptcy, retirement, or expulsion) of a member because it destroys the mutual agency which exists among the members of a general partnership. A Maryland LLC which is structured to follow the Act's default provisions should lack the corporate characteristic of continuity of life because an event such as the death, retirement, or bankruptcy of a member will automatically cause the dissolution of the entity. The business of the entity may thereafter only be continued with the consent of all of the remaining members. Md. Code Ann. § 4A-901.

Free Transferability of Interests - An organization will generally have the corporate characteristic of free transferability of interests if each of its members, or those members owning substantially all of the interests in the organization, have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. Section 4A-604 provides that the assignee does not become a member or exercise any rights of a member unless the remaining members unanimously consent. Additionally §4A-902 provides that an LLC is dissolved when a person ceases to be a member, such as, for example, by withdrawal from the LLC.

Virginia Limited Liability Act

As in Maryland, the Virginia legislature has enacted the Virginia Limited Liability Company Act which is found in the Va. Code §13.1-1000 through §13.1-1073. The Act establishes the terms of the parties' relationship if they have no articles of organization or operating agreement or if they fail to address particular issues. These "default rules" are designed to ensure that the LLC will lack at least three of the corporate characteristics of: (1) limited liability; (2) continuity of life; (3) centralized management; and (4) free transferability of interests, and thus will be categorized as a partnership for federal income tax purposes.

The relevant provisions of the Virginia LLC Act are as follows:

Limited Liability - Va. Code §13.1-1019 provides that no member of an LLC, their manager or other agent, shall have any personal obligation for any liabilities of a limited liability company, unless such liability is expressly provided in the articles of organization. Thus, like Maryland, if the members follow the default rules, the organization will possess the corporate characteristic of limited liability.

Centralized Management - The Virginia Act also provides for the management of a limited liability company to be vested in its members, unless the articles of organization provide otherwise. Va. Code §29-1317

Continuity of Life - Virginia Code §13.1-1046 provides that an LLC will be dissolved upon the happening of an event described in the articles of organization or operating agreement, or upon the unanimous written consent of the members, or upon the death, resignation, expulsion, bankruptcy or dissolution of a member or occurrence of any other event that terminates the continued membership of a member. In addition a Virginia LLC will be dissolved upon the entry of a judicial decree of dissolution.

Free Transferability of Interests - Unless otherwise provided in the articles of organization or operating agreement, a membership interest in an LLC is assignable in whole or in part. An assignment of an interest in an LLC does not of itself dissolve the limited liability company. Va. Code §13.1-1039. However, in accordance with the Virginia Act, an assignee of an interest in an LLC may become a member only by the consent of a majority in interest of the remaining members. Va. Code § 13.1-1040.

District of Columbia Limited Liability Company Act

Similarly, the District of Columbia Code also contains a section, in the Corporations section of the D.C. Code entitled Limited Liability Companies. D.C. Code §29-1301 through §29-1375. The D.C. LLC Act defines a limited liability company as an entity that is an unincorporated association, without perpetual duration, having two or more members that is organized and existing under the Act. Like the Maryland and Virginia LLC Acts, the District of Columbia LLC Act establishes the terms of the parties' relationship if they have no articles of organization or operating agreement or if they fail to address particular issues, and the "default rules" contained within the provisions of the Act are designed to ensure that the LLC will lack at least three of the corporate characteristics of: (1) limited liability; (2) continuity of life; (3) centralized management; and (4) free transferability of interests, and thus will be categorized as a partnership for federal income tax purposes.

Limited Liability - D.C. Code §29-1314 specifically provides that no member, manager, employee, or other agent of an LLC shall have any personal obligation for any debts, obligations, or liabilities of a limited liability company.

Centralized Management - D.C. Code §29-1317 provides for the management of an LLC company to be vested in its members, unless the articles of organization provide for management of an LLC by a manager or managers.

Free Transferability of Interests - D.C. Code §29-1335 states that a member's financial rights in the LLC are assignable in whole or in part. However, the assignment of a member's financial rights does not entitle the assignee to become a member. D.C. Code §29-1336 states that a member may assign the member's full membership interest only by assigning all of the member's governance rights coupled with a simultaneous assignment (to the same assignee) of all of the member's financial rights. Governance rights are assignable, in whole or in part, however, only as provided in the section.

Continuity of Life - In accordance with D.C.'s LLC Act, an LLC is dissolved upon the happening of the time or the event specified in the articles of organization or an operating agreement, upon the unanimous consent of the members with voting rights, upon the death, retirement, resignation, expulsion, bankruptcy or dissolution or other event terminating the continued membership of an LLC member. It should be noted that this section provides for several exceptions to this rule, that if fully complied with, will result in the continued legal existence and business of the limited liability company. D.C. Code §29-1347.

Liability Exposures of Members and Managers

Under the statutory provisions the debts and obligations of the LLC are those of the LLC, and a member or manager will not be personally liable for the payment of such debts and obligations. Additionally, the failure to observe all of the formalities of the statutory requirements will not, in and of itself, be grounds to impose personal liability on the members. It must, however be kept in mind that members and managers will always be independently liable for their own acts of negligence, just as the corporate director, officer or stockholder is. The only protection afforded by the statutory provisions governing LLCs is the liability arising solely because of member or manager status. Acts constituting dual status or outside the scope of authority or individual acts of negligence are not protected under the statute.

Members of a limited liability company are generally the owners. Managers are those selected by the members to manage the entity. In some states, the term manager may

refer to each of the members, if the articles of organization or the operating agreement do not otherwise provide.

One of the difficulties in insuring the risks associated with the operation and management of a Limited Liability Company is the identification of the individuals who are the managing members responsible for a given operation or function. Therefore, one major problem for the insurer and insured is in identifying the potential exposure of members and managers and how to insure them.

While the law in the area of the liability of members and managers of Limited liability Companies is still developing, a review of the general law of tort liability as well as the liability of analogous business organizations, it may reasonably be predicted that the potential liability for the wrongful conduct of LLC members is analogous to the liability faced by officers and directors of a corporation and that the potential liability faced by officers and directors of a corporation will be similar to the potential liability facing members and managers of a limited liability company.

Under the LLC statutes, Limited Liability Companies can be managed by either the members or by managers in accordance with an operating agreement. In a member managed company, each member retains authority to make business decisions. Therefore, it is reasonable to predict that a member in an LLC so structured will face potential liability similar to that imposed on partners of a partnership, or on general partners of a limited partnership.

In manager-managed LLC's, one or more managers are selected by the members and are granted authority to transact company business. Their role is therefore analogous to that of a corporate officer in the conduct of the corporation's business and affairs. Accordingly, the liability of managers is analogous to the liability of corporate officers. The scope of liability can vary in accordance with the obligations, authority and duties set forth in the operating agreement. Such liability can also be altered by virtue of contractual risk transfer agreements, such as indemnity and hold harmless agreements, exculpatory agreements, and limitation of liability agreements.

Therefore, it is essential in determining the risk exposure of members and managers of LLCs to review the terms and provisions of the operating agreement as well as any other contractual risk transfer documents. In the event that management duties and obligations are set forth in an operating agreement and are negligently performed or not performed at all, such conduct will result in liability exposure.

In view of the fact that the members of a LLC can also participate in management, unlike the role of a shareholder or the role of a limited partner, while retaining the liability shield, they generally are not liable above their contribution, and therefore

liability is limited in nature. However, it must be clearly understood that LLC status does not afford full and unlimited protection from liability to its members. To the extent that members retain control of certain duties and obligations, they will similarly face corresponding liability risks. Members and Managers of a LLC face exposure for losses generated by the decision-making process.

Members of a LLC may also face liability for undercapitalizing the business entity by not at the time of formation have sufficient assets on hand to pay projected losses or obligations. A LLC will not be allowed to defeat a recovery of a third party if doing so would defeat public policy or justify a wrong, fraud, or criminal act, under the rationale that by imposing liability on the shareholders or owners they will be discouraged from forming risky businesses unless they can afford a proper amount of capitalization or insurance. One form of undercapitalization is the failure to adequately insure exposures the LLC will face during the course of normal business operations.

Most states defining limited liability companies state that members shall not be personally liable for liability because of their status as such in a LLC. However, they further state that the statute will not be construed to affect the liability of a member to third parties for the member's participation in tortious conduct or pursuant to the terms of a written contract. Additionally, the conduct of a member leading up to liability of a LLC could be the source of litigation by other members against the member whose act, error or omission generated the liability imposed upon the LLC.

Fiduciary Responsibilities

In addition to general liability for wrongful conduct a member/manager of a LLC can be subject to claims of breach of fiduciary duties, similar to such claims against an officer or director of a corporation. Such claims can consist of 1) the asserted failure to ensure that records and minutes were properly kept and maintained; 2) the failure to properly form or maintain the LLC or to insure the operations of the LLC; 3) the breach of the duties set forth in an operating agreement by a manager; 4) acts of a manager which is outside the scope of the operating agreement; and 5) failing to adequately insure the business organization.

Other Liability Exposures

Members also face liability exposure related to the association of a LLC with another business organization based upon a conflict of interest or due diligence failure. Liability can also arise to third parties and by, between and among members for conduct impairing the rights of other members or the LLC itself. Actions may arise based upon the allegations that a member or manager has acted without the consent of

members, or for jeopardizing the tax status of the LLC. Members and managers may also face liability with respect to the marketing and sale of membership interests, and for fraud or misrepresentation related thereto.

Insurance Coverage and the Indemnity Obligation

In view of the fact that most participants in a LLC have a financial investment in the company, they will want to protect their investment and any personal liability that they may have by contractual risk transfer and by insuring the risks presented. Without insurance, the LLC can only rely upon its assets in the event of a claim or suit, which is entirely unacceptable in today's business climate.

Several courses are generally taken by the insurance industry in insuring the risk exposures faced by members and managers of limited liability companies as well as the companies themselves. The first course is underwriting a separate policy of insurance specially designed for LLC exposure. The second is for the insurer to utilize an existing directors and officers (D&O) liability policy modified by endorsement to tailor coverage to the exposures of a LLC. Care must be taken to provide coverage under the LLC policy to the members and managers as well as the LLC, otherwise a gap in coverage is likely to occur.

A critical coverage consideration is for the operating agreement to empower the LLC to indemnify its members. In the event that the operating agreement does not clearly set forth the obligations which it imposes on members, fails to properly identify them, or does not clearly set forth an indemnity agreement, the coverages afforded become more dependent on the applicable law as opposed to the operating agreement.

If an operating agreement does not sufficiently identify a managing member or managers or the indemnity obligation to members, coverage difficulties will arise in policy interpretation.

The insuring agreement of a policy designed as a LLC policy has two insuring agreements;

(1) The first states that the insurer has the obligation to pay on behalf of the managing members the amount of loss sustained a result of a claim alleging a wrongful act by managing members solely in their capacity as such. (2) The second insuring agreement consists of two sub-parts. Sub-part (a) requires the insurer to reimburse the LLC for loss which the LLC has lawfully indemnified or was obligated to indemnify the managing member resulting from a claim alleging a wrongful act by managing members solely in their capacity as such. This same insuring agreement of the policy

is set forth in sub-part (b), with the distinction that sub-part (b) applies to managers as opposed to managing members.

The insuring agreement of the endorsement for use with a D&O policy agrees to pay loss of any duly appointed or designated member of the board of managers arising out of a wrongful act. The second insuring agreement of the endorsement agrees to reimburse the LLC for loss arising from any alleged wrongful act to the extent the LLC has indemnified the members of the board of managers pursuant to law, contract, charter or by-laws of the LLC.

Other Coverage Provisions

It is important to consider the other provisions of some of the policies designed for LLCs in order to make certain that the desired coverage has been underwritten. One of the problem areas is the tax advantage representations that an LLC may make to members. One policy excludes liability alleging, arising out of, based on, or attributable to (1) any representations made in connection with obtaining any tax benefits for the entity or its members; (2) the failure to obtain any tax benefits for the entity or its members; or (3) the failure to maintain the conditions necessary to continue providing the benefits for the entity or its members.

Also there may be cross over coverage from a commercial general liability policy for some loss exposures facing members and managers of a limited liability company, such as personal injury coverage and other coverages afforded in umbrella policies which traditionally have broader coverages.

Although the insurance requirements for LLCs are in the developing stages, it is certain that there is a need to carefully review the structure of the particular LLC in order to clearly define the liability risk exposure and the contractual risk transfer(s) that are applicable in order to address those needs by the underwriting of a policy which is specifically tailored to meet the needs of the particular LLC and its members and managers.

WORKS CITED

I. Malecki on Insurance Vol. 6, Number 4

This publication was relied upon for the publication on Limited Liability Companies, principally in connection with the Liability Exposures of Members and Managers and Insurance Coverage and the Indemnity Obligation.

II. Case Authority as Cited throughout.

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