Let’s Stop Describing LLCs as “Hybrids”

By Thomas E. Rutledge

In *Turner v. Andrews*, the Kentucky Supreme Court wrote that “A limited liability company is a ‘hybrid business entity having attributes of both a corporation and a partnership.’”1 Similar descriptions can be found in decisions of other courts.2 While a description of an LLC as “a hybrid business entity having attributes of both a corporation and a partnership” may have been substantially correct in the early days of the LLC,3 today this formula is misleading and impoverished in that it indicates that partnership and corporate law are in some manner melded in the LLC and that when considering a dispute involving LLCs, the question is whether to apply one or the other to a particular question.

In a realm in which limited liability is available in not only the LLC but also in general and limited partnerships,4 as well as other unincorporated forms such as the limited cooperative association5 and the statutory trust,6 citing the corporation as the archetype for limited liability is misleading, especially as that characteristic is not intrinsic to the corporate form.7 As to tax classification, many LLCs are not taxed as partnerships but rather as either associations taxable as corporations or as disregarded entities.8 Furthermore, many LLCs otherwise classified as disregarded entities are required to be treated as corporations for certain employment tax purposes.9 In today’s environment, the LLC, like each other form of business organization, must be understood as a unique construct of formulae and characteristics that may or may not be shared with other organizational forms.10

First and foremost, an LLC is an organizational form that is based on a contract identified as the “operating agreement.”11 Where an LLC does not adopt a particular agreement as its operating agreement, the LLC Act will itself constitute the operating agreement.12 An LLC may supplement the Act with oral agreements as to particular points,13 but under the laws of certain states oral agreements will not be effective when the LLC requires that any departure from its terms be in writing.14 Assuming the operating agreement is in writing, there is almost complete flexibility to structure the internal affairs of the LLC. It is the express public policy of many states to give maximum effect to the freedom of contract in operating agreements.15 This organizational flexibility sets the LLC off from the corporation, a form in which there is limited opportunity in the articles of incorporation or...
the by-laws for modification of the standard form as set forth in the business corporation act.\textsuperscript{16}

Second, the LLC is entirely a statutory construct. Partnerships, limited partnerships and corporations predate the law governing each being reduced to statute.\textsuperscript{17} In contrast, LLCs are entire strangers to the common law; there was no LLC before there was an LLC Act. The Kentucky Supreme Court, in \textit{Pannell v. Shannon}, observed:

In fact, “limited liability companies are creatures of statute,” controlled by Kentucky Revised Statutes (KRS) Chapter 275, not primarily by the common law. To the extent that common law doctrines could arguably govern limited liability companies, the Kentucky Limited Liability Company Act “is in derogation of common law,” and the traditional rule of statutory construction that “require[s] strict construction of statutes that are in derogation of common law shall not apply to its provision.” Thus, to the extent the statutes conflict with common law, the common law is displaced.\textsuperscript{18}

\textbf{In today’s environment, the LLC, like each other form of business organization, must be understood as a unique construct of formulae and characteristics that may or may not be shared with other organizational forms.}

While aspects of the laws of other business organizations were utilized as models in drafting certain aspects of the various LLC acts, they were simply models. LLCs have certain characteristics because those characteristics are embodied in the governing statute, not because an LLC is a “different flavor” of one of the older organizational forms. Therefore, instead of analogizing an LLC to one of the older organizational forms, the LLC needs to be understood as a separate business organization that has characteristics that may be similar to those of other organizational forms. The point is subtle but important; by way of example:

- LLCs are not similar to partnerships because both embody the rule of \textit{in personam delectus}, but rather LLCs and partnerships are similar to one another because they both embody the rule of \textit{in personam delectus}; and

- LLCs are not similar to corporations because both afford limited liability to the owners (members and shareholders), but rather LLCs and corporations are similar to one another because they both provide limited liability to the owners.

Third, an LLC is not a species of partnership, and it is not a species of corporation. LLCs are formed under and governed by an LLC act.\textsuperscript{19} LLCs are not as a default governed by the law of corporations. The law of corporations is not a general “gap filler” for the law of other business organizations. Corporate law governs corporations, and that is all it governs.\textsuperscript{20} LLCs are not as a default governed by the law of partnerships. In fact, partnership law expressly provides that it does not apply in business organizations formed under other organizational statutes.\textsuperscript{21} Rather, an individual LLC is governed by its operating agreement (incorporating as it does the LLC Act) and then by law and equity.\textsuperscript{22}

Fourth, treating an LLC as a hybrid dependent for its characteristics to analogies to a previously existing form deprives the LLC of any independent functionality. As eloquently described by Professor (now Dean) Tom Geu, the LLC exists to fill a gap that otherwise exists in the law of business organizations.\textsuperscript{23} The LLC is intended to provide a different answer to certain questions, to provide an alternative organizational paradigm that was not available under the previously available forms such as the partnership and the corporation. For that reason, it both packages pre-existing concepts in a unique manner and as well provides rules with no antecedent. In that manner, the LLC provides a unique set of rules different from the prior forms, a uniqueness lost if it is treated as a mere hybrid.

In the end, an LLC is simply that—it is an LLC in the same way that a corporation is a corporation and a partnership is a partnership. Each of those labels is simply the identifier of a unique combination of characteristics. Addressing only some of those characteristics:

LLCs share certain characteristics with corporations such as limited liability and “entity” characterization. That said, even as none of the statutes actually define what it means to be an “entity,”\textsuperscript{24} LLCs share those same characteristics of limited liability and entity characterization with RUPA limited liability partnerships.\textsuperscript{25} Some LLCs share with partnerships a management structure in which the owners, as owners, control the operations of the venture even as there are other LLCs that have separated management control from ownership, vesting control of at least the day-to-day operations of the LLC in persons other than in their capacity as members and even persons who are not members at all.\textsuperscript{26} While the former of these models is akin to a partnership management structure and
**FIGURE 1.**

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Partnership</th>
<th>LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Limited Liability:</strong></td>
<td>Shareholders enjoy limited liability from the corporation’s debts and obligations[1]</td>
<td>Partners are personally liable for all of the partnership’s debts and obligations[2]</td>
</tr>
<tr>
<td><strong>Free Transferability of Interests:</strong></td>
<td>Corporate shares are freely and unilaterally transferable[4]</td>
<td>Right to participate in management not freely transferable[5]</td>
</tr>
<tr>
<td><strong>Centralized Management:</strong></td>
<td>Control of the corporation is vested in the board of directors; directors need not be shareholders[7]</td>
<td>Control of the partnership is vested in the partners[8]</td>
</tr>
<tr>
<td><strong>Capital Lock-In:</strong></td>
<td>A shareholder may not withdraw from and thereby liquidate the investment in the corporation[10]</td>
<td>A partner may unilaterally withdraw from the partnership and liquidate interest in the partnership[11]</td>
</tr>
<tr>
<td><strong>Agency:</strong></td>
<td>A shareholder is not an agent for the corporation[13]</td>
<td>A partner is an agent for the partnership[14]</td>
</tr>
<tr>
<td><strong>Major Decisions:</strong></td>
<td>Major decisions require approval of the board of directors and a majority of the shareholders[15]</td>
<td>Major decisions require unanimous approval of the partners[16]</td>
</tr>
<tr>
<td><strong>Voting Rights:</strong></td>
<td>Shareholders vote in proportion to share ownership[18]</td>
<td>Partners vote on a per capita basis[19]</td>
</tr>
<tr>
<td><strong>Voluntary Dissolution:</strong></td>
<td>Requires the approval of the board of directors and a majority of the shareholders[21]</td>
<td>Automatic upon the resignation of any partner[22]</td>
</tr>
<tr>
<td><strong>Treatment under Federal Securities Laws</strong></td>
<td>“Stock” is a definitional security[24]</td>
<td>Partnership interest may be a “investment contract,” but there is a contrary presumption[25]</td>
</tr>
<tr>
<td><strong>Default Treatment under UCC</strong></td>
<td>Stock is an Article 8 certificated security[27]</td>
<td>Interest in a partnership is an Article 9 general intangible[28]</td>
</tr>
</tbody>
</table>

**ENDNOTES**

1 See, e.g., Del Code Ann. tit. 8, §102(b)(6); Ind. Code §23-1-26-3(b); Ky. Rev. Stat. Ann. §2718.6-220(2). The statute is silent as to the limited liability of directors, officers, employees and agents.
4 See, e.g., 12 WILLIAM MEADE FLETCHER, FLETCHER Cyclopedia of the LAW of CORPORATIONS §5452 (2012) (“The owner of the shares, as in the case of other personal property, has an absolute and inherent right, as an incident of his or her ownership, to sell or transfer the shares at will, except insofar as the right may be restricted by the articles of incorporation, bylaws, an agreement among shareholders, or between shareholders and the corporation. In the absence of such restrictions, a transfer of shares does not require the consent of the corporation and cannot be prohibited.”) (citations omitted); CHARLES B. ELLIOTT, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §427 (3d ed. 1900) (“A transferee of shares acquires the rights of the transferrer….”). Still, shares of a professional corporation are typically transferable only to members of the profession practiced by the PSC. See, e.g., Ky. Rev. Stat. Ann. §274.017.
7 See, e.g., Del Code Ann. tit. 8 §141(a), (b); Ind. Code §§23-1-33-1(a)-(b); Ky. Rev. Stat. Ann. §2718.8-010(2); id. §2718.8-020. See also Allied Ready Mix Co., Inc. v. Mattingly, 994 SW2d 4, 8 (Ky. 1998).
See, e.g., *Nixon v. Blackwell*, 626 A2d 1366 (Del. 1993) (shareholder has no right to have corporation repurchase shares absent a contract to that effect); *Blaustein v. Lord Baltimore Capital*, 84 A3d 954 (Del. 2014) (same). A different rule applies under certain professional corporation statutes, they providing a default right to put the shares in the absence of a contrary agreement. See, e.g., Ky. Rev. Stat. Ann. §274.095. This rule is not however universal. See, e.g., *Corlett, Killian, Hardeman, McIntosh and Levi, P.A. v. Merritt*, 478 So2d 828 (Fla. 2nd DCA 1985) (no right of shareholder to compel redemption).


14 See, e.g., Del. Code Ann. tit. 6, §18-603; Ind. Code §23-18-6-6.1(b); Ky. Rev. Stat. Ann. §275.280(4). Admittedly there are LLC acts that embody different rules. See, e.g., Del. Code Ann. tit. 6, §18-604 (if member is afforded the right to withdraw from LLC, absent contrary private ordering, the member is upon resignation entitled to the “fair value” of his interest therein).

15 See, e.g., Del. Code Ann. tit. 6, §18-603; Ind. Code §23-18-6-6.1(b); Ky. Rev. Stat. Ann. §275.280(4). Admittedly there are LLC acts that embody different rules. See, e.g., Del. Code Ann. tit. 6, §18-604 (if member is afforded the right to withdraw from LLC, absent contrary private ordering, the member is upon resignation entitled to the “fair value” of his interest therein.).
the latter perhaps akin to that of a corporation, (i) the LLC is unique in its capacity to make that election and (ii) the centralized management of a manager-managed LLC does not carry with it the “two-house” rule of corporate law. While under no corporation act a shareholder as a shareholder an agent of the corporation and under every partnership act each partner is an agent for the partnership, some LLCs elect to have the members qua members as agents, while others elect the exact opposite result.28 The suggestion of hybridization fails when a review of characteristics shows the supposed hybrid to lack characteristics of either predecessor form.29

Returning to the early guidance of Professor Geu is perhaps the best direction:

The Limited Liability Company (“LLC”) is a unique and relatively new form of business organization created by statute.30

Therefore, consideration of an LLC must begin by a careful analysis of its operating agreement and the underlying LLC Act. These two sources collectively embody the law of that particular LLC. Only in the rarest of instances will there be a need to reference law other than general contract law in applying that combination of private agreement and statute to assess the rights of the members, the managers and even third-parties dealing with the LLC.

While recourse to the law of other organizations may be appropriate to understand particular statutory language, reference is appropriate because of the similarity of statutory formulae are different, which the LLC is to be measured. Where, in contrast, the statutory formulae are different, the LLC agreement governs relations among the members, the managers, and the assignees; the Kentucky Limited Liability Company Act shall govern relations among the members as members and between the members and the LLC. To the extent the [LLC] agreement does not otherwise provide for a matter described in subsection (a)(1), this Act governs the matter."

See also Del Code Ann. tit. 6, §18-101(7) (limited liability company agreement may be oral); Rev. Prototype Limited Liability Company Act §102(14), 67 Bus. Law. 117, 129 (Nov. 2011) ("[T]he [LLC] agreement governs relations among the members as members and between the members and the LLC. To the extent the [LLC] agreement does not otherwise provide for a matter described in subsection [a](1), this Act governs the matter.").

1 Carter G. Bishop & Daniel S. Kleinberger, Limited Liability Companies: Tax and Business Law ¶ 1.01 (2012) (“The limited liability company (LLC) is a relatively new, hybrid form of business entity that combines the liability shield of a corporation with the federal tax classification of a partnership.... The essence of an LLC is the co-existence of partnership tax status with corporate-like limited liability.”).


7 See, e.g., William L. Clark, Jr., HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS 16 (Francis B. Tiffany ed., 2d ed. 1907) (stating that limited liability is "not an essential attribute" of the private corporation).

8 See Reg. §301.7701-3.

9 See Reg. §301.7701-2(c)(2)(iv)(A).


12 See, e.g., Ky. Rev. Stat. Ann. §275.003(8) ("To the extent the articles of organization and the operating agreement do not otherwise provide, the Kentucky Limited Liability Company Act shall govern relations among the limited liability company, the members, the managers, and the assignees."); Rev. Prototype Limited Liability Company Act §110(a)(1)-(2), 67 Bus. Law. 117, 136 (Nov. 2011) ("[T]he [LLC] agreement governs relations among the members as members and between the members and the [LLC]. To the extent the [LLC] agreement does not otherwise provide for a matter described in subsection [a](1), this Act governs the matter.").

13 See, e.g., Del Code Ann. tit. 6, §18-101(7) (limited liability company agreement may be oral); Ky. Rev. Stat. Ann. §275.015(20) (operating agreement may be oral); Rev. Prototype Limited Liability Company Act §102(14), 67 Bus. Law. 117, 129 (Nov. 2011) (limited liability company agreement may be oral).

14 See, e.g., Ky. Rev. Stat. Ann. §275.170; id. §275.180; id. §275.220 (each requiring that departure from statutory rule be in a “written operating agreement”).

15 See Del. Code Ann. tit. 6 §18-1101(b) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of [LLC] agreements."); Ky. Rev. Stat. Ann. §275.003(1) ("It shall be the policy of the General Assembly through this chapter to give

ENDNOTE

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maximum effect to the principles of freedom of contract and the enforce-
ability of operating agreements.

By way of example, a corporation must have an officer charged with control of the corporation’s records, and that officer must be identified as the “secretary.” See, e.g., Ind. Code §23-1-20-22; id. §23-1-36-1; Ky. Rev. Stat. Ann. §271B.8-400(3), id. §271B.1-400(23). The relative rights of the classes of shares in the corporation must be set forth in the publicly filed articles of incorporation, and the shareholders have cumulative voting only if that right is recited in the articles of incorporation. See, e.g., Ind. Code §23-1-25-1(a); Ky. Rev. Stat. Ann. §271B.6-010, id. §271B.7-280(1). The fiduciary standards of a director are not subject to modification by a government, and a committee of directors charged to review and pass upon a conflict transaction must have at least two directors. See Ky. Rev. Stat. Ann. §271B.8-300(1); id. §271B.8-310(3).

See, e.g., Karl Moore and David Lewis, Foundations of Corporate Empire, 32–33 (Prentice Hall 2000) (discussing the terms of an investment partner-
tion date of an LLC, the standard set out in the business corporation oppression of an LLC member); Denike v. Cupo, 394 N.J. Super. 357, 378, 926 A2d 869 (App. Div. 2007) (in the context of choosing a valuation date of an LLC, the standard set out in the business corporation act could not be used because LLCs are governed by the limited liability company act).