



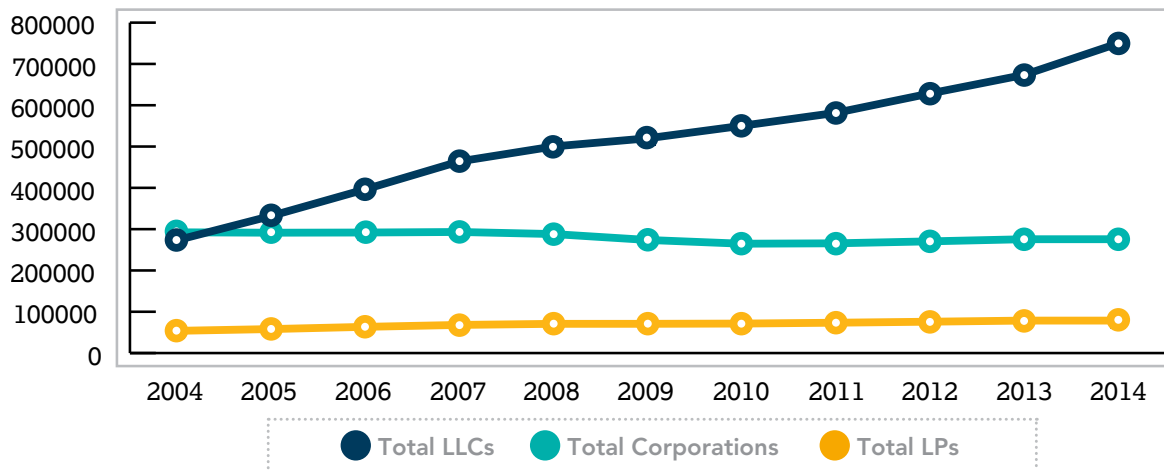
FLEXIBLE FLYER

**THE DELAWARE LLC
SOARS TOWARD
THE QUARTER-CENTURY MARK.**

The Rise of the Delaware LLC

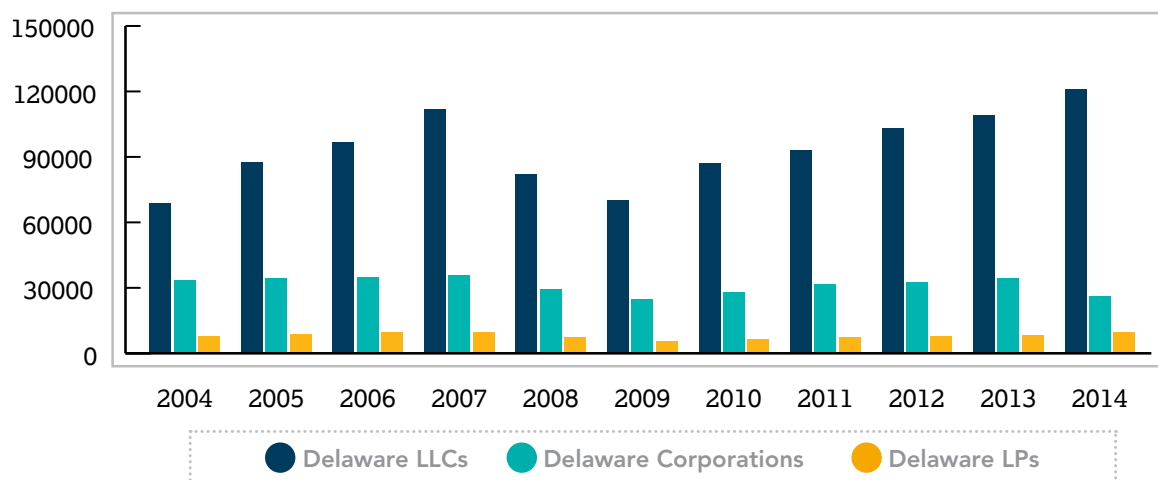
Total Number of Delaware Limited Liability Companies, Corporations, and Limited Partnerships

Today nearly two-and-a-half times more LLCs than corporations call Delaware their legal home.



New Delaware Limited Liability Companies, Corporations, and Limited Partnerships

In 2014 alone, more than 121,000 LLCs were formed in Delaware.



The world took little notice when, in 1977, Wyoming Governor Edgar J. Herschler signed a law enabling a new kind of business entity to be formed in his state: the limited liability company, or LLC.

It would be another decade before the Internal Revenue Service ruled that limited liability companies could be treated as partnerships for tax purposes and thus enjoy “pass-through” taxation, sparing them the hit of “double taxation” that corporations generally face.

Before the LLC’s arrival, the twin virtues of limited personal liability and pass-through taxation came standard only with the IRS sub-chapter S Corporation, which has its own shortcomings, including strict limits on the number of shareholders and a U.S. citizenship requirement for owners. The LLC, on the other hand, presented a kind of SUV of legal entities: It offered the safety and durability of the corporation combined with the nimble handling of the partnership form. It was wide-ranging, too—open to owners from around the world.

Today it’s hard to imagine the U.S. business landscape without the LLC. And much of that familiarity, it should be noted, has to do with the State of Delaware, which passed its own limited liability company act in 1992, 15 years after Wyoming’s “soft opening.”

Delaware’s business-friendly reputation certainly has contributed to the Delaware LLC’s popularity, but so has the significant contractual flexibility this entity type offers. The Delaware LLC is now an indispensable entity for many commercial real estate, investment fund, M&A, and securitized lending transactions.

For insight into the current workings of Delaware LLCs, CSC spoke with **Robert L. Symonds, Jr.**, and **Matthew J. O’Toole**, two attorneys who boast long histories with the Delaware LLC Act. Symonds was one of the act’s original drafters and has served as chairman of the committee responsible for amending the statute, on which O’Toole also has served. The two men also literally wrote the book on the subject, as co-authors of CSC Publications’ **“Symonds & O’Toole on Delaware Limited Liability Companies”** (Lexis Nexis, 2015).

Today Symonds and O’Toole are partners at the Wilmington, Delaware, law firm of Potter Anderson & Corroon LLP. They were gracious enough to take some time out of their very busy schedules to meet with CSC and discuss the Delaware LLC, its advantages and what pitfalls businesses need to be aware of when considering the LLC for corporate use.



CSC: In your book, “Symonds & O’Toole on Delaware Limited Liability Companies,” you repeatedly describe the Delaware LLC Act as “preeminent.” What accounts for that preeminence?

S The Delaware LLC Act’s preeminence is part of Delaware’s larger preeminence as a place to form business entities. As you know, our state is a hub for corporate and commercial law. That’s in part because of what we call the “Delaware Advantage”—we’ve got a well-developed body of corporate and business entity law backed up by lots of case law, expert judges, and a legislature and a governor who are interested in keeping the business entity statutes fair and balanced and responsive to the needs of the marketplace. The LLC Act is also supported actively by the Delaware bar, which takes a hands-on role in formulating amendments to the statute for consideration by the legislature.

CSC: So the Delaware LLC Act continues to evolve? It’s a “living document?”

O Absolutely.

S The LLC Act was enacted in 1992, and since then I believe it’s been amended every year but one.

CSC: Presumably it's in Delaware's best interest to stay competitive at attracting new LLC formations. How does the state do that?

S In a couple of ways. The Delaware State Bar Association has a drafting committee, which begins meeting in September of every year and meets almost weekly until it finalizes any proposed amendments, usually in February or March. We talk about new or creative uses of provisions in the statute. You've got attorneys who have a lot of experience in the area who are meeting on a more or less continual basis during the legislative session to craft refinements to the law. It's a thoughtful, deliberative process.

Only after the statutory amendments proposed by our committee have been vetted by the bar association as a whole are they sent to the Delaware General Assembly for legislative consideration. Attorneys who worked on the drafting usually are called to testify before the legislature. It's a collaborative process among the bar, the business community, the legislature, and the governor's office. That's the process by which we maintain preeminence.

CSC: You've described Delaware LLCs as having "broad contractual flexibility." Can you give a practical example of that?

C Sure. Maybe the best example is in the area of fiduciary duties. In the context of a Delaware corporation, there's flexibility to arrange management structures and economic rights and various other matters within the company. One thing you cannot change in the corporate context, however, is the principle that directors of the corporation have fiduciary duties of care and loyalty to the company and its stockholders.

By contrast, the LLC Act allows for not just restriction, but outright elimination, of fiduciary duties pursuant to an LLC agreement. So broad contractual flexibility generally means the ability to tailor intra-company arrangements as the parties to the LLC agreement see fit. Fiduciary duties and the ability to modify them may be the foremost examples of that contractual flexibility.

S That's right. If you spend any time looking at the Delaware LLC Act, you're going to be struck by how many times the lead-in language to a particular provision says something like, "unless otherwise provided in the LLC agreement" or "except to the extent otherwise provided in the LLC agreement." The statute provides what we call "default rules." In most instances, though, it defers to the LLC agreement, which is the contractual instrument governing the LLC. In addition, the statute also says that its policy is to promote freedom of contract and the enforceability of LLC agreements. When you combine that language with the default rule structure of the statute, you have broad contractual flexibility.

CSC: How common is it for LLCs to produce their own, tailored agreements?

S Generally speaking, sophisticated parties will tailor their LLC agreements to match up with their desired business structure and other business arrangements. That's the reason they're using the LLC. They want to implement the particular business deal on which they've agreed, not a default rule arrangement. We certainly would recommend that parties consider adopting an LLC agreement that is tailored to their situation, rather than just relying on the default rules.

CSC: But the default rules are fundamentally sound, correct?

S Default rules provide reasonable structure in the absence of an agreement. So in that sense, yes, the default rules are sensible. They also tend to be pretty "vanilla." So if there are special things that are in your business arrangement, relying on the default rules probably is not going to get you where you want to be.

CSC: How would you characterize the popularity of Delaware LLCs compared to those in other states?

S If you look at a state like Florida, it may have more LLCs than Delaware does, but many of those would be local in nature—for example, Florida real-estate ownership LLCs. Generally, if people are forming LLCs other than under the laws of the state where they're located, they're going to look at Delaware. It all goes back to the "Delaware Advantage" and that flexibility we mentioned.

CSC: Are there reasons for the popularity of Delaware LLCs beyond the "Delaware Advantage" and their inherent flexibility?

C LLCs are popular generally because of the favorable tax treatment they offer, coupled with contractual flexibility, which is not unique to Delaware, although we think we have some advantages over other states. And of course, they do offer limited liability for the members and the managers of the company. If you're an investor in an LLC, your investment in the company may be at risk, but as a general rule your house isn't.

CSC: The popularity of the Delaware LLC must draw some attention. Are there any external regulatory pressures being brought to bear on Delaware and the Delaware LLC Act?

O One pressure point, and it's not unique to Delaware LLCs—it's an international issue—is the idea of "entity transparency," where the owners of a business entity ought to be known to everybody, or so the theory goes.

S Delaware's LLC Act contains provisions that respond to that desire for transparency. Our statute prohibits "bearer shares," or "bearer interests," in an LLC. With a bearer interest, whoever holds the certificate—and it can change from day to day—is the owner. Bearer shares may be common elsewhere, but the Delaware LLC Act prohibits them.

O Another initiative this legislative session will make explicit is a requirement that has been implicit in the LLC Act for some time, and that is that an LLC must maintain a record of the names and addresses of its members and managers.

CSC: Is there anything we should know about pass-through taxation and its advantages?

O Pass-through taxation is an advantage of LLCs generally, not just Delaware LLCs. It reduces the overall tax burden that is borne by the entity and its owners. An example helps you to understand it better. Say you have a corporation, a "C" corporation for federal income tax purposes, and let's say the company earns \$100 of income. The company pays corporate rates of income tax on that money. We'll say 30% for this example.

S So that means that the company is left with \$70. And then let's say the company pays that entire amount out to its stockholders as a dividend. The stockholders would then have \$70 worth of income that would be subject to taxation. Let's say that \$70 gets knocked down to something like \$50. If you have pass-through tax treatment, if the LLC has \$100 worth of income, that \$100 basically gets passed through for tax purposes directly to the members. So the members then would pay tax on \$100 at their applicable tax rate. You wouldn't have that second bite of taxation at the entity level and then again at the investor level.

O That's long been true for partnerships. The federal tax laws providing generally for pass-through tax treatment of LLCs really helped spur the growth of LLC formations. The simple and ready availability of pass-through tax treatment was just another reason to use an LLC.

CSC: Can you give some examples of how LLCs are used?

O They're used in a whole host of situations. They're used to hold real estate. They're used for operating companies. They're used for forming investment funds. They're used for special purpose entities, or SPEs, to hold a particular asset or assets for a very limited purpose. They're ideal for that because you can have single-member LLCs, which are used in a lot of structured finance and securitization transactions. There are even more creative uses, including "series" LLCs.

CSC: One more question—can you name a situation in which an LLC would be an inappropriate entity type?


S One of the things we talk about in our book is that an LLC may not be the best type of entity for a public company. The flexibility inherent in an LLC can reduce the ability of investors to make assumptions about the rules that apply to a company in which they're investing. For example, in an LLC, you can have a modification of fiduciary duties, which can't happen in a corporation setting. Having an LLC requires more due diligence of public investors. But the fact is, notwithstanding our view that maybe it's not the best entity for a public company as a general matter, there are publicly held LLCs out there. So it's not necessarily inappropriate. It's maybe less efficient to some extent to have a publicly traded LLC as compared to a publicly traded corporation.

O I think that's a good way of thinking about it, because anytime you need a business entity to do something, an LLC deserves consideration, generally speaking.



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