

New D.C. Business Organizations Code: Major Overhaul for Better Business Climate : Part Two

Published in the Washington Lawyer Magazine: December 2011, Volume 26 No. 4

By Nicholas G. Karambelas



This is the second installment of a two-part series. Part two examines the final five chapters of the code.

On February 27, 2011, the District of Columbia enacted legislation that represents its first effort to fundamentally and comprehensively revise the District's existing entity statutes, which were enacted between 1870 and 1962. The District of Columbia Official Code Title 29 (Business Organizations) Enactment Act of 2010 replaces Title 29 of the D.C. Code. The new Title 29—known as the D.C. Business Organizations Code—adopts the concept of a unified entity code. The law takes effect for all existing entities, except existing limited liability companies (LLCs), on January 1, 2012, and for all entities formed after that date. The law takes effect for existing LLCs on January 1, 2013.

Limited Liability Companies (D.C. Code § 29-801.01 et seq.)

The District of Columbia was one of the last jurisdictions to adopt a limited liability company (LLC) statute. The new Title 29 enacts the Revised Uniform Limited Liability Company Act (RULLCA). An LLC combines the advantages of a corporation with the advantages of a partnership. A properly formed LLC can possess both the limited liability of a corporation and the pass-through tax treatment of a partnership. Unlike a partnership, an LLC can neither be implied at law nor exist by estoppel. An LLC is an unincorporated association that is a separate legal entity distinct from its members. An LLC has perpetual duration. A member can be a natural person, corporation, partnership, foreign person/entity, or another LLC. An LLC can sue or be sued, enter into contracts, and hold title to property—all in its own name.

An LLC can be formed for any lawful purpose, including a nonprofit purpose. Professionals can render professional services through an LLC as long as each member and manager is a licensed professional, and the professional service is the only purpose of the LLC. Members may limit the powers of an LLC or restrict how its powers are exercised as long as the limit or restriction is contained in the articles of organization. The doctrine of limited liability applies to LLCs just as it applies to corporations. A member of an LLC is not a proper party to a cause of action by a third party against the LLC, nor can the personal assets of a member be used to satisfy a judgment against the LLC solely because that person is a member of the LLC. An LLC is classified as an association and taxed as a partnership, unless the LLC elects to be taxed as a corporation under the self-classification regulations of the Internal Revenue Service (IRS).

An LLC can be managed by its members or its members may appoint managers—members or nonmembers—to oversee the LLC. If members do not appoint managers, the LLC is deemed to be managed by its members.

Terms

Certificate of Organization—A document that identifies an LLC and is filed with the governing authority. A filing of a certificate of organization commences the legal existence of an LLC. It is the functional equivalent of the articles of incorporation or a certificate of limited partnership.

Manager—A person hired by an LLC to manage or operate the business of the LLC. A manager can but need not be a member.

Member—A person who owns an interest in an LLC and is the functional equivalent of a partner or shareholder.

Membership Interest—A percentage of an LLC's interests owned by a member at any particular time. All benefits, liabilities, and obligations contemplated by the members will flow to the members in accordance

with their respective membership interests. A membership interest is the functional equivalent of ownership interests in a partnership and shares of a corporation. It consists of governance rights, financial rights, and management rights.

Operating Agreement—A contract made by members governing the relationship between an LLC and its members, and the relationship among its members. Serving the same purpose as a partnership agreement or a shareholder agreement, the operating agreement orders the affairs of the LLC and the manner by which business will be conducted.

Organizer—Any person who executes a certification of organization.

Pre-Formation Agreements and Formation

Before an LLC is formed, two or more persons who intend to become the initial members of an LLC may conclude the terms, conditions, and provisions for an operating agreement and agree that those terms, conditions, and provisions will be the operating agreement of the LLC once it is formed. A person who intends to be an initial member of an LLC also may conclude the terms, conditions, and provisions for an operating agreement, which will be the operating agreement of the LLC once it is formed.

The existence of an LLC commences when the certificate of organization is filed. The certificate must contain at least the following information:

- Name of the LLC,
- Registered agent and address,
- Address of the initial principal office, and
- Statement that the LLC will have a series of membership interests, if so.

The Operating Agreement

Like the Revised Uniform Partnership Act (RUPA) and Revised Uniform Limited Partnership Act (RULPA), the RULLCA is a default statute. If the members have not agreed on an issue, then the RULLCA governs any such issue. The operating agreement or any portion of it can be oral, in a record, or implied, or any combination of oral, recorded, or implied elements. Along with Minnesota, New York, and Wisconsin, the District of Columbia required that an operating agreement be in a record/writing to be enforceable. The absence of a record/writing requirement in the RULLCA is a fundamental difference between the old Title 29 and the RULLCA. After January 1, 2012, an operating agreement or any provision of an operating agreement that is oral is presumptively enforceable. However, if the operating agreement comes within the statute of frauds, the operating agreement must nevertheless be in a record/writing.

The RULLCA sets forth certain mandatory provisions, but it primarily distinguishes between items that members cannot either vary or eliminate, items members can vary but not eliminate, items members cannot restrict, and items members cannot unreasonably restrict. The old Title 29 does not make these distinctions among the mandatory provisions.

Members cannot vary any of the following:

- The capacity of an LLC to sue or be sued in its own name,
- The principle that the law of formation governs the internal affairs of the LLC and that each member and manager is afforded limited liability,
- The power of a court to act on a petition to compel a person to file a certificate of organization,
- The power of a court to dissolve an LLC, or
- The requirement that a dissolved LLC must wind up.

Members cannot eliminate but may vary in a manner consistent with the RULLCA any of the following:

- The duty of loyalty,

- The duty of care,
- Any other fiduciary duty, or
- The contractual obligation of good faith and fair dealing.

Members cannot restrict any of the following:

- The right to approve a merger, conversion, or domestication of an LLC to a member who would have personal liability in the resultant entity, or
- The rights of any person, other than a member or manager, except the rights of a judgment creditor.

Members cannot unreasonably restrict either of the following:

- The right to LLC information and inspection of LLC records, or
- The right of a member to maintain a derivative action.

Fiduciary Duties

As between and among members, the RULLCA maintains the principle that there are no fiduciary duties unless members agree to impose fiduciary duties. As between or among members in a member-managed LLC, members may restrict or even eliminate fiduciary duties as long as any such restriction or elimination is not manifestly unreasonable.

Indemnification

An LLC must reimburse and indemnify a member for any payment, debt, obligation, or other liability incurred by a member of a member-managed company, or the manager of a manager-managed company in the course of a member's or manager's activities on behalf of the LLC, as long as the act of any such member or manager was not an improper distribution or did not violate the standards of conduct for members and managers under the RULLCA. Members may agree to alter or eliminate the foregoing indemnification obligation as long as the act of a member or manager is not any of the following:

- Breach of the duty of loyalty,
- A financial benefit to which the member or manager is not entitled,
- An improper distribution,
- Intentional infliction of harm on the LLC or a member, or
- An intentional violation of law.

The old Title 29 simply enables members to agree to limit or restrict the liability of a member or manager in any action brought by or on behalf of an LLC or its members unless the action is premised on willful misconduct.

Rights of Oppressed Minority Members and Derivative Actions

A member may assert a cause of action directly against an LLC, a member, or a manager to protect its interests in the LLC. A member also may assert a derivative action on behalf of the LLC.

Series of Membership Interests

Probably the most controversial development in the law of LLCs is the concept of series of membership interests. The concept has been a part of the Delaware LLC Act since 1996. Illinois, Iowa, Nevada, North Carolina, Oklahoma, Tennessee, Texas, and Utah also have enacted series provisions. As promulgated, the RULLCA does not have a series provision. However, the RULLCA, as enacted by new Title 29, does have a series provision.

A series of membership interests may own its own assets, pursue its own business purpose, and is afforded its own limited liability. A series can incur obligations to third persons and those obligations can be enforced

only against the assets of that series and not against the assets of any other series or the assets of the LLC. The following requirements must be satisfied for a series to be validly formed:

- The certificate of organization must state that the LLC will form a series of membership interests;
- The LLC files a certificate of series designation for each series that the LLC creates, containing a name that is different from the LLC but including the entire name of the LLC and a registered agent, registered office, and principal office, if any of them are different from the registered agent or office of the LLC;
- Records for the series must be maintained in a manner that is separate and distinct from the records of any other series of the LLC and the LLC itself; and
- The assets of the series must be accounted for separately from the accounts of assets of any other series or the assets of the LLC.

A series is in good standing as long as the LLC is in good standing. The certificate of organization may provide that a series is a separate entity distinct from the LLC, any other series, or its members. A series may pursue any lawful purpose, including a nonprofit purpose or a purpose that is different from the LLC and each other series. A series can sue or be sued in its own name and has any power necessary or convenient to pursue its purpose.

The RULLCA governs the internal affairs of a series and the liability of a member or manager of a series as a member or manager of that series. Unless otherwise agreed, the members of the series manage the series. The dissolution and winding up of a series does not dissolve the LLC or any other series. A series cannot merge or be acquired by another entity apart from the LLC. All other default provisions under the RULLCA that apply to LLCs also apply to series. The series concept can be most advantageous where an LLC has several valuable assets, and each of which has associated with it different magnitudes of actual or potential liabilities. In nonseries LLCs, a creditor cannot enforce an obligation of the LLC against the members of the LLC, but that creditor can enforce the obligation against all assets of the LLC, including those assets that were not the subject of the particular obligation. The only means by which a nonseries LLC can protect valuable assets from creditors while maintaining overall control of the assets is to create separate LLCs linked through mutual ownership of membership interests. Creating and maintaining separate LLCs can be inefficient and expensive. The series concept can eliminate the need to create and maintain separate LLCs to protect separate assets. When organizing series of membership interests, members should consider whether or not foregoing burdens are outweighed by the requirement to create and maintain separate records and accounts.

The series concept raises questions as to how a series will be treated under other laws. Such questions include:

- Since few states have enacted series provisions, whether a series of a foreign LLC will be afforded limited liability in a jurisdiction whose LLC statute does not contain a series provision.
- Whether a series by itself can file for bankruptcy laws, and, if so, whether the members of the series make that decision without the participation of the other LLC members.
- Whether an LLC can file one tax return or whether each series must file separate returns. The IRS has proposed regulations under which a series is treated as a separate legal entity for tax classification purposes.

Administrative Provisions

The RULLCA enables an LLC to be initially formed without any members so that, as a practical matter, there is time to determine who will be a member and to allow the deal to gestate. The initial certificate can state that there are no members. If the organizer decides to proceed, the organizer must file a notice, no later than 90 days after that filing, stating that there is at least one member and the date on which any such member became a member. The LLC is deemed to have been formed as of the date on which the notice is filed. If no notice is filed, then the first filing lapses.

A charging order is a lien of a judgment creditor against a member to satisfy a judgment obtained by the judgment creditor against the member. A proper charging order requires an LLC to pay a judgment creditor any distribution that would otherwise be payable to a member. A charging order acts essentially in the same manner as a garnishment. Neither a judgment creditor nor a receiver appointed to administer the assets of a member acquires any right to manage or govern an LLC. The old Title 29 is essentially the same as the RULLCA provision.

Member Liability in Professional Service LLCs

A professional cannot be held liable for acts of negligence, wrongful acts, or misconduct committed by another professional in an LLC, or for acts committed by persons under the supervision or control of another professional in an LLC, merely because the member holds a membership interest in the LLC. However, a professional who commits acts of negligence, wrongful acts, or misconduct, or acts which are committed by persons under the supervision or control of that professional, will be personally liable for any such acts.

Maintenance of LLC Records

An LLC must create and maintain certain basic information and records at its principal office. Each member has the right, upon reasonable request, to inspect the information and copy any records. The required information and records include the names and identifying information of each member; copies of the articles of organization as they may be amended and the certificate of organization as it may be amended; copies of all local, state, and federal tax returns and reports for the three most recent years; and copies of any operating agreement. If not contained in the operating agreement, an LLC must maintain a written description of the contribution of each member; the times, if any, at which additional contributions must be made; any right of a member to receive or of the LLC to make a return of contribution; and the occurrence of any event that will cause the LLC to dissolve and the winding up of the business of the LLC.

Failure of an LLC to create and maintain the required information and records will not cause it to lose its status as an LLC. However, an aggrieved member could seek and most likely obtain injunctive relief against the LLC for failure to maintain the required information and records.

Becoming a Member After Formation

After an LLC is formed, a person may become a member by acquiring a membership interest either directly from the LLC or as an assignment from a member. If a person acquires the interest from the LLC, then all members must consent to the transaction unless members have agreed to a lesser margin of consent. Members may agree to a margin that is less than a majority of the interests.

If a person acquires the interest through an assignment from a member, then that person becomes a member only if the assignment includes both the financial and governance rights of the assigning member. If a person is assigned only the financial rights of the assigning member, that person may receive the profits and distributions of the assigning member but cannot become a member. A person may become a member without acquiring a transferable interest and without making or being obligated to make a contribution to the LLC.

Transfer of Membership Interest

A member may transfer its financial rights in whole or in part and, unless otherwise agreed upon by the members, need not obtain any consent or approval from the other members. The transferee of financial rights can receive the assignor's share in profits, losses, and distributions, but it cannot participate in governance or management. Unless otherwise agreed upon by the members, a transfer of financial rights does not make the transferee a member and does not dissolve the LLC.

A member may transfer membership interest only by transferring governance and management rights as well as financial rights to the same transferee. Members may agree to require either a more restrictive or lesser margin of consent for such transfer. After the other members have duly consented, the effect of a transfer of governance rights is that the transferee becomes a member and the transferor ceases to be a member. The personal representative of a deceased member may exercise such rights of the deceased member as necessary to protect the interests of the estate.

Dissociation and Expulsion of a Member

A member has the power to dissociate at any time. Whether such dissociation is rightful or wrongful depends on the conditions set forth in the operating agreement. An LLC may expel a member as set forth in the operating agreement or for conduct by a member.

Dissolution and Winding Up

An LLC must dissolve and wind up upon the occurrence of an event specified in the certificate of organization or the operating agreement, upon the unanimous consent of its members, upon judicial dissolution, or if the LLC has no members for 90 consecutive days. No other event can cause an LLC to dissolve and wind up.

Litigation

An LLC can sue or be sued in its own name. Even though an LLC is a distinct legal entity separate from its members, it is treated as a partnership rather than as a corporation for federal diversity subject matter jurisdiction purposes. See 28 U.S.C. §§ 1331, 1332; *Carden v. Arkoma Associates*, 494 U.S. 185 (1990). Consequently, the state citizenship of each member of an LLC must be completely diverse from the state citizenship of each opposing party.

General Cooperative Associations (D.C. Code § 29-901.01 et seq.)

The District of Columbia enables the formation of a cooperative for any business purpose. The new Title 29 retains the current general cooperatives law. A cooperative is an incorporated association but not a corporate body. Although a cooperative incorporates, it can only form under the general cooperatives law, not under the general corporations law. A cooperative is an entity owned and democratically controlled by persons who use the goods or services of the cooperative, and the business benefits are distributed equitably among the users based on the magnitude of the use that each user makes of the goods or services. A cooperative is based on three interrelated principles: member-owner principle; member-control principle, and member-benefits principle. The business purpose of a cooperative is to purchase and market the products or services of its members and procure supplies for resale to members. A member of a cooperative is afforded limited liability, which can be disregarded in the same way as the limited liability protection for shareholders and LLC members.

Limited Cooperative Associations (D.C. Code § 29-1001.01 et seq.)

The new Title 29 enacts the Uniform Limited Cooperative Act. It enables persons to invest in cooperatives under certain circumstances without becoming a member of the cooperative. Subject to certain limitations, investors may receive a return on their investment.

Unincorporated Nonprofit Associations (D.C. Code § 29-1101.01 et seq.)

An unincorporated nonprofit association (UNA) is an unincorporated organization consisting of two or more members who agree either orally or in writing to pursue a nonprofit purpose, or who act in a manner so that joint pursuit of a nonprofit purpose can be implied. A UNA cannot be a trust, marriage, formed under any other statute that governs the organization and operation of unincorporated associations, joint tenancy, tenancy in common, or tenancy by the entireties.

Terms

Governing Principles—An agreement outlining how the operations and internal affairs of a UNA are conducted. It may be oral, in a record/writing, or implied from the conduct of members.

Manager—A person who directs the operations and affairs of a UNA.

Member—A person who, under the governing principles, may participate in the selection of the manager(s) or in the development of the policies and activities of a UNA. A member is not an agent for a UNA solely by reason of being a member.

Default Provision on Fundamental Governance Issues

Unless the governing principles state otherwise, a UNA cannot take any of the following actions unless each member agrees:

- Admit, suspend, dismiss, or expel a member;
- Select or dismiss a manager;
- Adopt, amend, or repeal the governing principles;
- Sell, lease, exchange, or otherwise dispose of all, or substantially all, of the UNA property, with or without the goodwill of the UNA, except in the ordinary course of its activities;
- Dissolve or merge;
- Undertake any other act outside the ordinary course of activities of the UNA;
- Determine the policy and purposes of the association; or
- Commit any other act or exercise any right for which the governing principles require approval by all of the members.

Default Provision on Method of Decision Making

Unless the governing principles state otherwise, members must decide an issue, other than a fundamental governance issue, by an affirmative vote of a majority of the members, with each member having one vote. There are no default provisions for notice of meetings, quorum, or conduct of meetings.

Obligations of Members

Each member has the fiduciary duty of good faith and fair dealing to a UNA and to each member of a UNA. No member has any other fiduciary duty to the UNA or to another member of the UNA solely by reason of being a member. Unless the governing principles state otherwise, a member may resign at any time. Unless the governing principles state otherwise, neither the interest of the member nor any right of membership can be transferred.

Rights and Duties of the Manager

Unless the governing principles state otherwise, members choose the manager. The manager need not be a member. If members do not choose a manager, then each member is deemed to be a manager and management decisions are made by a majority vote of the member-managers. The manager shall manage the UNA in good faith and in a manner the manager reasonably believes to be in the best interests of the UNA and consistent with the prudent person and business judgment rules. A manager may rely in good faith upon any opinion or other information that derives from a source the manager reasonably believes is competent and reliable. A manager has the fiduciary duties of loyalty and care to the UNA and to each member of the UNA. The governing principles may limit or eliminate the liability of a manager to the UNA or the members for damages for any action taken, or for failure to take any action as a manager. The governing principles cannot limit or eliminate the liability of a manager for the amount of a financial benefit improperly received by the manager, an intentional infliction of harm on the UNA or its members, an intentional violation of criminal law, breach of the duty of loyalty, or improper distributions.

Information

Upon reasonable notice, a member or manager may inspect and copy any records maintained by a UNA involving its activities, financial condition, and other circumstances, to the extent that the information is material to the member's or manager's rights and duties under the governing principles. Such inspections should be made during regular operating hours and at a reasonable location specified by the UNA. A UNA may impose reasonable restrictions and charges on access to UNA information.

Financial Matters

Unless the governing principles state otherwise, a UNA cannot pay dividends or make distributions to a member or manager. Even without a statement in the governing principles and unless prohibited by the terms of any tax-exempt status it has been granted, a UNA may:

- Pay reasonable compensation or reimburse reasonable expenses to a member or manager for services rendered,

- Confer benefits on a member or manager consistent with its nonprofit purposes,
- Repurchase a membership and repay a capital contribution made by a member to the extent authorized by its governing principles, or
- Make distributions of property to members upon the winding up and termination of the UNA.

Dissolution and Winding Up

A UNA dissolves as set forth in the governing principles, as otherwise directed by the members, by court order, or by operation of law if it has no members and has not operated for three years. After dissolution, the UNA continues in existence until its activities have been wound up. In the wind up, the UNA must pay its debts and properly dispose of its property as required by any other applicable laws. If no other laws are applicable, then after the payment of debts, the UNA pays the current members on a per capita basis or as the current members direct.

Statutory Trust Entities (D.C. Code § 29-1201.01, et seq.)

The new Title 29 enacts the Uniform Statutory Trust Entity Act, also known as a business trust (BT). A BT is also referred to as a Massachusetts trust or a common law trust. A BT may conduct any lawful business, but not insurance or banking. The primary purpose of a BT cannot be a donative purpose. A BT is a separate legal entity and distinct from the beneficial owner. A BT may sue or be sued, enter into contracts, and hold real and personal property—all in its own name. BTs are afforded limited liability.

Terms

Beneficial Owner—The actual owner of the property of a BT.

Certificate of Trust—A document that is filed to commence the existence of a BT.

Governing Instrument—A trust instrument that creates the trust and sets forth the terms and conditions of governance and management. It must be in writing.

Trustee—A person or entity appointed to manage the affairs and business of the trust.

Formation and Powers

A BT is formed by filing a certificate of trust containing the following:

- Name of the BT,
- Registered agent and address of registered office, and
- Initial principal office.

Management

A BT is managed by a trustee(s). The beneficial owner can be a trustee. The trustee may appoint officers to act for or on behalf of the BT.

Governing Instrument

A governing instrument is the functional equivalent of an operating agreement or shareholder agreement. A governing instrument sets forth the terms of governance and management of a BT as determined by the beneficial owner. A governing instrument shall not:

- Vary the requirements for commencing the existence of the BT;
- Choose a law other than District of Columbia law to govern the BT;
- Negate the exclusion of a predominantly donative purpose;
- Vary the provisions pertaining to series of trusts;
- Vary the standards of conduct for trustees, although the governing instrument may prescribe the reasonable standards by which good faith, best interests, and care that a person in a similar position would reasonably believe appropriate under similar circumstances are determined;
- Vary the obligation of a trustee to act in good faith;

- Restrict the right of a trustee to BT information;
- Vary the prohibition on indemnification, advancement of expenses, or exoneration for conduct involving bad faith, willful misconduct, or reckless indifference by a trustee;
- Vary the obligation of a trustee not to follow a direction that is manifestly contrary to the terms of the governing instrument or would constitute a serious breach of fiduciary duty by the trustee;
- Restrict the right of a judgment creditor of a beneficial owner to seek a charging order;
- Restrict the right of a beneficial owner to BT information;
- Restrict the right of a beneficial owner to bring a direct action or derivative action;
- Vary the provisions on mergers;
- Vary the provisions on dissolution; or
- Vary the provisions on foreign BTs.

Series of Trusts

A BT may form series of trusts that are similar in concept to series of member interests in an LLC. The primary difference is that a series of trust can never be a separate legal entity distinct from the beneficial owners.

Dissolution

A BT has perpetual duration. It can dissolve only as provided in the governing instrument or by administrative action