An Overview of the Delaware Limited Liability Company Act

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The DLLC Act

Delaware’s reputation as the premier jurisdiction for corporate entities is well known. In recent years, however, Delaware has also emerged as a leader in providing cutting-edge alternatives to the traditional corporate form. One example of this leadership can be seen in Delaware’s Limited Liability Company Act, 6 Del.C. § 18-101, et seq. (the “DLLC Act”), which governs the most popular “alternative” business entity: the Delaware limited liability company (“DLLC”). The DLLC has rapidly become an entity of choice for business owners, advisors and investors, and can provide tax advantages (and in some cases, business advantages) over the corporation.

A DLLC may engage in virtually any lawful business activity, including manufacturing, services, holding and developing real estate, holding and managing intangible property such as securities and other investments, and acting as a special-purpose entity in financing transactions. The principal advantages of a DLLC are avoidance of double income taxation, unmatched contractual flexibility, and, of course, limited liability. A DLLC may be structured in virtually any manner that best suits the business needs of the parties. This flexibility can make the DLLC preferable to the traditional corporation and, in many cases, to other alternative business entities such as limited partnerships or general partnerships.

Limited Liability

One of the most appealing aspects of the DLLC is the limited liability afforded to a DLLC’s owners and operators. The DLLC Act generally refers to owners of a DLLC as “members,” and to persons designated to manage the business and affairs of the entity as “managers.” Members of a DLLC may, but are not required to, be managers of the DLLC, thus opening the door for investors or other non-managerial persons or entities to enjoy the benefits of the DLLC. The DLLC Act provides that no member or manager is liable personally for any debt, obligation, or liability of a DLLC solely by virtue of such party’s status as a member or manager. In addition, the DLLC Act expressly empowers a DLLC to “indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever.” This limitation on personal liability and the broad scope of permissible indemnification compare favorably with the
corresponding protections enjoyed by stockholders, officers, and directors of a Delaware corporation.

**Contractual Flexibility**

The basic approach of the DLLC Act is to let the parties define their business relationship in the limited liability company agreement, and to provide rules only for those matters on which the parties have failed to agree. A stated policy of the DLLC Act is to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements. This important policy means that the parties can predictably create and maintain the relationships that best suit their business needs. For instance, in their limited liability company agreement, the parties may provide for various classes of members or managers (with each class enjoying different rights, powers, and duties, including separate voting rights, economic rights or managerial rights), or even classes of limited liability company interests or assets (with each class having different rights, powers and duties with respect to specified property, to profits and losses, and even having different business purposes). In fact, the parties may by agreement determine nearly all aspects of their relationship with one another. To the extent that a member or manager has duties (including fiduciary duties) to the DLLC or to another member or manager, the DLLC Act provides that the limited liability company agreement may expand or restrict or eliminate such duties (other than the implied contractual covenant of good faith and fair dealing). This flexibility arises from Delaware’s longstanding policy favoring freedom of contract.

**Management Flexibility**

The principle of contractual freedom manifests itself particularly in management flexibility, a cornerstone of the DLLC Act. The parties can select the management arrangement that works best for them. Under the DLLC Act, members of a DLLC can participate in management without jeopardizing their limited liability, or they may elect to have the DLLC managed by someone else, or fashion a blend of these two approaches. The limited liability company agreement may provide for different classes of managers, each having such rights, powers, and duties as are provided therein. The limited liability company agreement also may contain provisions relating to the exercise of voting rights, including provisions relating to notice of the time, place, or purpose of any meeting at which any matter is to be voted on, waiver of any such notice, action by consent without a meeting, quorum requirements, and rules for voting in person or by proxy. Members and managers of a DLLC generally are free to transact business with the DLLC. Experienced entity services providers in Delaware frequently are willing to furnish or serve as an administrator or “independent” manager of a DLLC whenever needed [e.g., for a business reason such as satisfying the requirements of a lender to the DLLC].

**Business Combination Flexibility**

In addition to flexibility at the creation and operational stages of a DLLC’s existence, the DLLC Act offers the parties a number of ways to restructure the DLLC. For example, under the DLLC Act, a DLLC may merge or consolidate with another DLLC, or with an “other business entity” (including, but not limited to, corporations, statutory trusts, common-law trusts, associations and partnerships), whether any such other business entity is formed or organized under the laws of Delaware or another jurisdiction. Delaware offers additional flexibility by permitting reorganization of a DLLC by way of asset sales, conversions and transfers. Further, the DLLC Act even permits business entities formed under the laws of another jurisdiction to convert to or domesticate as a DLLC without ceasing business operations or necessitating the winding up and termination of the original business entity.
Ease of Formation

A DLLC is easy to form and maintain. Formation of a DLLC requires only: (1) a limited liability company agreement of the member or members (which need not be written); and (2) the filing of a certificate of formation with the Delaware Secretary of State. A DLLC is deemed to have been formed at the time the certificate of formation is filed with the Delaware Secretary of State. While the certificate of formation is required only to set forth the name of the DLLC and the name and address of the DLLC’s registered agent and registered office in Delaware, it may also contain any other matters that the members determine to include therein.

A limited liability company agreement is a private contract between the members. It is not a public document. Therefore, under the DLLC Act the identity of a DLLC’s members and managers, and the terms of their relationships, can remain confidential. The DLLC Act does not specify any minimum capital investment. Non-U.S. businesses and individuals generally are free to form and operate DLLCs because the DLLC Act does not require a member or a manager of a DLLC to be a natural person or a citizen or resident of the United States. Additionally, neither a DLLC’s records nor its principal place of business need to be located in Delaware. They may be located wherever is most convenient for the parties, including any jurisdiction outside the United States. Furthermore, such records may be maintained in electronic or other non-written form.

No Delaware Business Activities Required

There is no requirement that a DLLC carry on business activities or establish or maintain any place of business (other than a registered agent and registered office) in Delaware. With respect to the requirement of a registered agent/registered office in Delaware, there exists a vast number of service providers located in Delaware who, for a minimal fee, will provide such services.

Aside from a minimal annual fee (referred to as a “franchise tax”) payable to the State of Delaware, a DLLC is not obligated to pay taxes either to the United States federal government or to the State of Delaware solely by virtue of the fact that the DLLC is formed under the laws of Delaware. In general, a DLLC may become subject to income taxation by the State of Delaware if it conducts business in the State of Delaware or if it receives income from a source in the State of Delaware. Similarly, a DLLC may become subject to income taxation by the United States government if it conducts business in the United States or it receives income from a source in the United States.

Avoidance of Double Taxation

As a matter of U.S. federal income tax law, a DLLC may be structured so that it will not be subject to tax at the business organization level. Therefore from a tax perspective the DLLC offers a very attractive alternative to the corporation, which typically is taxed at the organization level. The members of a DLLC may specifically agree to such tax treatment in their limited liability company agreement. Of course, the contractual freedom afforded by the DLLC Act enables the members to agree to other tax treatment if they so desire.