RECENT DEVELOPMENTS

A Step in the Right Direction: Washington Passes the Limited Liability Company Act

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I. INTRODUCTION

On April 1, 1994, Washington passed the Limited Liability Company Act.¹ In doing so, the Washington Legislature provided Washington businesses with the option of an organizational form that

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combines the characteristics of limited-liability and pass-through taxation: the Limited Liability Company (LLC). Before the creation of the LLC, businesses typically had to choose between pass-through taxation, found in partnerships, and limited liability, found in corporations. The LLC provides the best of both worlds.

The LLC option will benefit Washington State’s economy in two ways. First, Washington's LLC statute prevents exposure of LLC members and managers to personal liability. Without a LLC statute, businesses that attempted to operate under the LLC form would not have been guaranteed limited liability for their members and managers. Without an LLC statute the LLC's members and managers could be exposed to personal liability for the debts and obligations of the business. Such exposure would have created a great disincentive for LLCs organized in other states to do business in Washington. Second, the LLC form provides an additional option for Washington-based risk-averse investors and businesspersons to participate in the local economy. Therefore, although Washington has historically been viewed as a state hostile to business, the recent passage of the LLC Act is an indication that Washington is working to become an attractive forum to businesses on the local, national, and international levels.

This Article describes how and why the LLC Act was passed, and provides a general outline of the LLC form in Washington. Section II outlines the perceived barriers to operating a business in Washington state. Section III sets out a brief legislative history of the Act, including the attempts by the Washington State Trial Lawyers Association to block the legislation, and proposed amendments to the legislation. Section IV describes the specifics of the LLC entity by reference to the Washington Limited Liability Company Act. Section IV also presents the comparative advantages of LLCs to other business forms. Finally, Section V concludes by discussing the specific advantages LLCs can provide to Washington State by encouraging domestic and foreign investment in the local economy.


3. Treas. Reg. § 301.7701-2 (1994). Pass-through taxation and limited liability can also be found in an S-Corporation, but S-Corporations are greatly restricted in how they can be organized. See infra text accompanying notes 108-117 for a comparison of the LLC and the S-Corporation.


II. WASHINGTON'S BARRIERS TO BUSINESS

Washington has been viewed as a state hostile to business. With the combination of Governor Mike Lowry's increase in business and occupational taxes in 1993, and the subsequent tax-revolt, the general sentiment among local businesspersons has been one of increasing frustration over the difficulty and cost of operating as a business in Washington State. A survey conducted during the summer of 1993 found that nearly one in twelve Washington businesses indicated a forty percent chance or better of moving their firm out of state. Similarly, in early 1993 Boeing Chairman Frank Shrontz stated that a proposed superjumbo jet would be built outside of Washington because of the state's tax and regulatory burdens. Even as early as 1991, Shrontz "warned that the greater Seattle area could become another 'rust belt' if state government didn't work to make the business climate more attractive." According to Don Brunell, head of the Association of Washington Business, "Washington...has done things to discourage the creation of jobs."

In response to Lowry's 1993 increase in business and occupational taxes, the Association of Washington Business (whose members include Boeing, as well as thousands of smaller businesses) endorsed Initiative 602. This initiative would have repealed the recently imposed tax increases. The petition for Initiative 602 netted 440,160 signatures, more than double the number required to get the initiative on the ballot. And although Initiative 602 did not pass, its strong support evidenced a growing discontent with Washington's business climate, particularly among businesspersons. Even the business communities of Oregon and Idaho were beginning to view Washington as


8. Carlson, Lowry Leaps into Big Game Without Winning the Race, supra note 7, at B4.


10. Id.


13. Rebels up North, supra note 7, at D01.
having a less than desirable business climate.\textsuperscript{14} Idaho manufacturers called Lowry's tax increases "The Idaho Economic Development Act."\textsuperscript{15}

An undesirable business climate would make it difficult for Washington to compete economically, not only on a local and national level, but also on a global level. An inability to compete in these global markets would hurt Washington's government revenues and private-sector jobs.\textsuperscript{16}

Washington has taken two positive steps towards participating in the changing global markets: Mike Lowry's fervent support of the North American Free Trade Agreement (NAFTA), and Washington's enactment of the LLC enabling act. Lowry recognized the importance to Washington's economy of participating in global markets. With the passage of NAFTA and Washington's location on the Pacific Rim, Washington businesses are now in an excellent position to invest in transpacific, Canadian, and Mexican markets. According to Lowry, one of every five jobs in Washington is connected to international trade.\textsuperscript{17} Lowry has also predicted that because of the passage of NAFTA Washington's trade with Mexico will double in the next three years.\textsuperscript{18}

By passing the LLC Act, Washington has taken a step towards creating a friendlier climate for investment in the state's economy by providing a new organizational option for the changing global market. This option gives investors in the local economy substantially more flexibility in the way they are able to conduct business in Washington.

\section*{III. A Brief Legislative History}

This Section briefly outlines the major obstacles faced by the LLC Act in the Washington Legislature: opposition of the bill by the Washington State Trail Lawyers Association, and two proposed amendments.

\section*{A. WSTLA's Opposition}

Despite the LLC's potential economic benefits to the state, one Washington organization lobbied heavily against the bill as it was origi-
nally written. The Washington State Trial Lawyers Association (WSTLA) opposed the LLC Act because its members were concerned that allowing businesses to use the LLC business form as it was initially proposed would create two problems. First, WSTLA argued that, because no statutory remedy was included in the bill, certain classes of people who are injured by tortious acts of the LLC’s agents would be at the mercy of the company or the courts for compensation.\textsuperscript{19} WSTLA argued that because the LLC entity is relatively young, courts have not yet given shape to the company’s non-contractual duties to its members, creditors, employees, and to the members of the community within which the LLC operates.\textsuperscript{20} As a result, it is unclear which parties will be able to recover if injured by the actions of a LLC.\textsuperscript{21} WSTLA was concerned that third parties injured by the actions of a LLC would have no course for recovery.\textsuperscript{22}

Second, WSTLA was concerned with the potential for abuses by LLCs under the shield of limited liability.\textsuperscript{23} It argued that companies could use the LLC form to isolate their potentially risky products or activities from their assets.\textsuperscript{24} A corporation could lodge those risky products or activities in a subsidiary formed as an LLC.\textsuperscript{25} Because of the shield of limited liability, the member-corporation’s assets could remain protected in the event of accident or injury caused by that unsafe product or activity.\textsuperscript{26} Thus, WSTLA argued that the shield from liability would provide those companies with a safe harbor within which they could act irresponsibly without the threat of personal liability.\textsuperscript{27} Further, WSTLA claimed that even though a company could achieve limited liability protection by incorporating, it would choose the LLC form because of the tax advantages.\textsuperscript{28}

WSTLA also argued that members would have little incentive to adequately capitalize the LLC because it is taxed on an aggregate level.\textsuperscript{29} Thus, the LLC would have few assets from which the injured party could recover.\textsuperscript{30} And, because the LLC shields its members

\textsuperscript{19} Telephone Interview with Paul Chemmick, Lobbyist for the Washington State Trial Lawyer’s Association (Nov. 19, 1993).
\textsuperscript{20} Id.
\textsuperscript{21} Id.
\textsuperscript{22} Id.
\textsuperscript{23} Id.
\textsuperscript{24} Id.
\textsuperscript{25} Id.
\textsuperscript{26} Id.
\textsuperscript{27} Id.
\textsuperscript{28} Id.
\textsuperscript{29} Id.
\textsuperscript{30} Id.
from personal liability, the injured party would not be able to automatically reach beyond the entity to the assets of its members. Without a clear possibility of personal liability, parties would also have little incentive to obtain adequate insurance.\textsuperscript{31}

WSTLA argued that the government has a responsibility to protect the public generally from the tortious acts of others.\textsuperscript{32} While the trend in business has been towards encouraging economic growth, little emphasis has been placed on how stimulating that growth impacts the community. WSTLA asserted that the pursuit of economic prosperity should not undercut primary societal goals such as justice and equity.\textsuperscript{33}

\section*{B. Amendments to House Bill 1235}

Because of its concerns, the Washington State Trial Lawyers Association lobbied for two amendments to the bill: one requiring LLCs to obtain a minimum amount of insurance, and the other imposing personal liability on members and managers of LLCs engaging in hazardous or potentially dangerous businesses.\textsuperscript{34}

\subsection*{1. Amendment Requiring Liability Insurance}

Although the authors of the bill made a serious effort to draft statutory language embodying the WSTLA insurance proposal,\textsuperscript{35} it was not included because of the complexity of liability insurance coverages.\textsuperscript{36} Furthermore, this amendment would have created several problems.

First, requiring insurance would merely discourage a risk-adverse class of investors from engaging in business within the state. Those who want to avoid both the formalities of incorporating and the burden of double taxation, while reaping the benefits of limited personal liability, might choose to invest in another state that will provide them with the LLC form without the added insurance requirement. To remain competitive, Washington needed to maintain statutory uniformity with the states already providing the LLC business form. The insurance provision would have destroyed that uniformity.

Second, because insurance is not required of corporations or partnerships (forms as readily available to businesses as the LLC) the

\begin{itemize}
  \item \textsuperscript{31} Id.
  \item \textsuperscript{32} Id.
  \item \textsuperscript{33} Id.
  \item \textsuperscript{34} Id.
  \item \textsuperscript{36} Telephone Interview with William G. Pusch, Chair of the Partnership Law Committee of the Business Law Section of the Washington State Bar Association (Nov. 19, 1993).
\end{itemize}
insurance requirement would not have provided more protection. It would merely deter anyone who chose to conduct business within Washington from using the LLC form. Those desiring limited liability would still obtain it through incorporation.

However, the state legislature eventually agreed upon a minimum insurance requirement for professional LLCs. Under this requirement, professional LLCs, such as law or accounting firms, must maintain a policy of professional liability insurance, bond, or other evidence of financial responsibility. The minimum amount of insurance that must be maintained is one million dollars. If a professional LLC fails to maintain this required amount, the individual members will be personally liable to the extent that the insurance or bond would have covered the liability.

2. Amendment Imposing Personal Liability on Dangerous Business Activity

WSTLA also lobbied to remove the protection of limited liability from members of LLCs that engage in hazardous or potentially dangerous businesses. They argued that companies should not be able to use the LLC form to insulate themselves from this type of liability. According to WSTLA, the LLC should be designed to help those small businesses who are predisposed to acting responsibly.

Although the house judiciary committee initially added a second amendment that would have made LLC managers and owners personally liable for claims relating to hazardous substances and solid waste sites, the house and senate eventually passed the bill without the amendment.

Instead, the senate added a new section that requires the application of the "piercing the corporate veil" doctrine. The doctrine of

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38. Id.
39. Id.
40. Id.
41. Telephone Interview with Paul Chemmick, Lobbyist for the Washington State Bar Association (Nov. 19, 1993).
42. Id.
43. Id.
44. See Neurath, supra note 35, at 12.
46. Wash. Rev. Code § 25.15.060 (1994); 1994 Wash. Laws 211, § 112. For a discussion of this doctrine as applied to Washington corporations, see Grayson v. Nordic Constr. Co., 92 Wash. 2d 548, 552, 599 P.2d 1271, 1273 (1979). ("When the shareholders of a corporation . . . conscientiously keep the affairs of the corporation separate from their personal affairs, and no fraud or manifest injustice is perpetrated upon third persons who deal with the corporation, the corporation's separate entity should be respected . . . [However] the alter ego theory . . . is applied
piercing the corporate veil was created to internalize costs associated with irresponsible business practices.\textsuperscript{47} Courts impose this equitable remedy to provide compensation for those injured by such practices.

Prior to the passage of the LLC statute, it was not predictable how the courts would compensate injuries to third parties caused by a LLC. However, because LLCs share the characteristic of limited liability with corporations—the characteristic that gave rise to the judicial establishment of corporate accountability for irresponsible behavior—it was conceivable that courts would apply the doctrine of piercing the corporate veil to LLCs. By adding the new piercing the veil section, the legislature ensured that courts will apply this doctrine to LLCs.

Thus, the enacted provisions of the Washington LLC Act represent a compromise. WSTLA obtained some, but not all, of the protections it desired through the professional insurance and corporate veil-piercing provisions. Section IV details several of the remaining provisions contained in the Act.

IV. The Act

The Washington Limited Liability Company Act, as it was originally proposed, was drafted by the Partnership Law Committee of the Washington State Bar Association’s Business Law Section.\textsuperscript{48} Because a model LLC statute is not yet in existence, the drafters examined various state statutes before submitting one for consideration by the legislature. Washington’s provisions were modeled primarily after the Delaware LLC statute.\textsuperscript{49} Section IV discusses formation of an LLC under the Washington statute, and highlights the most significant characteristics of the LLC form. This Section concludes by presenting the benefits of the LLC form in relation to other organizational forms.

\textsuperscript{47} See Grayson, 92 Wash. 2d at 552, 599 P.2d at 1273 (1979) (holding that the corporate entity will be disregarded when principals themselves have disregarded it); Culinary Workers Union, Local No. 596 v. Gateway Cafe, Inc., 91 Wash. 2d 353, 366, 588 P.2d 1334, 1343 (1979) (holding that principals will be held personally liable when they have used the corporate entity for an improper purpose); Rena-Ware Distribs. v. State, 77 Wash. 2d 514, 518, 463 P.2d 622, 625 (1970) (holding that the corporate structure would not protect principals from personal liability where their actions have resulted in a fraud upon third persons); and Zander v. Larsen, 41 Wash. 2d 503, 511, 250 P.2d 531, 535 (1952) (holding that courts will pierce the corporate veil in order to defeat a “fraud, wrong, or injustice, at least where the right of third persons are concerned.”).

\textsuperscript{48} Pusch, supra note 36.

\textsuperscript{49} Id.
A. Forming a LLC

A LLC is formed by filing a "certificate of formation" with the Secretary of State, which must include the name of the LLC and the name and address of its registered agent within the State of Washington.50 One of the most attractive aspects of the LLC form is its ability to provide maximum flexibility in the formation and enforcement of LLC agreements.51 Members have very few restrictions on the design of their individual LLC. In fact, members may include in the certificate of formation any lawful provision which is not in conflict with the LLC Act.52

Capitalization of an LLC can be accomplished through contributions of cash, property, or services rendered.53 In addition, contributions can be in the form of obligations to contribute cash or property, or to perform services.54 Allocation of profits and losses, and distributions can be determined on the basis of those contributions, or by any other method which the members set forth in the certificate of formation.55 However, a LLC is precluded from making distributions that would leave the LLC unable to pay debts as they come due, or that would cause the LLC's liabilities to exceed fair value of its remaining assets.56 If a member knowingly receives a prohibited distribution, she will be held liable for the distribution if an action to compel repayment is instigated within three years from the date of the distribution.57

Once the certificate of formation is filed, the LLC may carry on any lawful business or activity, except banking or insurance.58 Unlike several other states' LCC statutes, the Washington Act specifically provides that LLCs formed in this state may engage in professional services.59 In addition, foreign LLCs60 are authorized to engage in the same activities that are authorized for domestic LLCs.61

51. Id. § 25.15.800(2).
52. Id. § 25.15.050.
53. Id. § 25.15.190.
54. Id.
55. Id. § 25.15.195.
56. Id. § 25.15.205.
57. Id.
58. Id. § 25.15.030.
59. Id. § 25.15.045; see also WASH. REV. CODE § 18.190 (1994). The Act permits organization of professional LLCs as long as the Act's minimum insurance requirement is satisfied. Id. § 25.15.045(2). See supra text accompanying notes 37-40. See also WASH. REV. CODE § 18.190 (1994).
60. For purposes of this discussion, the term "foreign LLCs" refers to LLCs from other states as well as from other countries.
B. Significant Characteristics

1. Limited Liability

If properly organized, the LLC provides limited liability for its members and managers in a manner similar to that of a corporation.\(^2\) However, unlike a corporation, the LLC avoids the double taxation problem.\(^3\) Thus, the LLC statute, as passed by the Washington State Legislature, allows businesses in Washington to reap the benefits of limited liability and pass-through taxation.\(^4\)

“Limited Liability” means that LLC members are generally not personally liable for the LLC’s obligations and liabilities to third parties.\(^5\) However, under two instances LLC members are liable to third parties: (1) when the member engages in intentional misconduct or knowing violations of the law,\(^6\) and (2) when the member commits a tort.\(^7\) LLC members are also generally not liable to the LLC or its members for acts or omissions on behalf of the LLC.\(^8\) However, a member is liable to the LLC or its members for those acts or omissions constituting gross negligence, intentional misconduct, or knowing violations of the law.\(^9\) In addition, a member is liable to other members if she benefited personally without the other members’ consent from a transaction connected with the conduct or winding up of the LLC, or from the use of LLC property.\(^10\)

2. Membership

An LLC can have an unlimited number of classes of membership.\(^11\) Such membership classes may be determined on any basis.\(^12\)

A person can become a member of an LLC either by obtaining an interest directly from the LLC, or by receiving an interest through assignment by a member.\(^13\) If the person receives an interest upon the formation of the LLC, she is admitted as a member upon formation or

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\(^{3}\) The LLC’s income is taxed like a partnership rather than being taxed as an entity. Rev. Rul. 88-76, 1988-2 C.B. 360.


\(^{5}\) WASH. REV. CODE § 25.15.125 (1994).

\(^{6}\) Id.

\(^{7}\) Id. § 25.15.125(2).

\(^{8}\) Id. § 25.15.155(1).

\(^{9}\) Id.

\(^{10}\) Id. § 25.15.155(2).

\(^{11}\) Id. § 25.15.120(3)-(4).

\(^{12}\) Id.

\(^{13}\) Id. § 25.15.115.
at the time specified in the LLC agreement, whichever is later.\textsuperscript{74} If she receives an interest directly from the LLC after its formation, she is admitted as a member at the time specified in the LLC agreement, or if there is no agreement, upon unanimous consent of all the members and a subsequent reflection of her admission in the LLC’s records.\textsuperscript{75}

If a person receives an interest through assignment, she would immediately acquire rights to share in the LLC’s profits, losses, and distributions to the same extent as the assigning member.\textsuperscript{76} However, she cannot be admitted as a member without unanimous consent of all the members (except the assigning member), unless otherwise provided in the LLC agreement.\textsuperscript{77}

3. Management

LLC management can be vested in its members,\textsuperscript{78} in which case all members have the authority to act as agents for the LLC.\textsuperscript{79} However the members can opt-out and provide for a manager(s), who does not have to be a member(s).\textsuperscript{80} Selection of a manager requires a vote, approval, or consent of members contributing fifty percent of the total value of the LLC.\textsuperscript{81} Limited liability extends to members and managers of a LLC.\textsuperscript{82}

4. Dissolution

Under the Act, dissolution occurs upon: (i) the date specified in the certificate of formation, or thirty years from the date of formation if no date is specified; (ii) the happening of events specified in the LLC agreement; (iii) the written consent of all members; or (iv) the entry of a decree of judicial dissolution.\textsuperscript{83} In addition, a LLC can be dissolved when any member dissociates, unless at least two members remain and unanimously consent to the continuation of the LLC within ninety days of the dissolution.\textsuperscript{84} Finally, the Secretary of State may dissolve

\begin{itemize}
  \item \textsuperscript{74} Id.
  \item \textsuperscript{75} Id.
  \item \textsuperscript{76} Id. \textsuperscript{\textsection}25.15.250(2)(a).
  \item \textsuperscript{77} Id. \textsuperscript{\textsection}25.15.115(2)(a), \textsuperscript{\textsection}260(1).
  \item \textsuperscript{78} Id. \textsuperscript{\textsection}25.15.150(1).
  \item \textsuperscript{79} Id. \textsuperscript{\textsection}25.25.150(1).
  \item \textsuperscript{80} Id. \textsuperscript{\textsection}25.25.150(2)(b).
  \item \textsuperscript{81} Id. \textsuperscript{\textsection}25.15.150(2)(a).
  \item \textsuperscript{82} Id. \textsuperscript{\textsection}25.15.155.
  \item \textsuperscript{83} Id. \textsuperscript{\textsection}25.15.270. Section 25.15.270 was taken from the Revised Uniform Limited Partnership Act (RULPA). See WASH. REV. CODE \textsuperscript{\textsection}25.10.440 (1994).
  \item \textsuperscript{84} WASH. REV. CODE \textsuperscript{\textsection}25.15.270 (1994). For a discussion of the ramifications of choosing the characteristic of continuity of life for a LLC, see infra text accompanying notes 93-99.
\end{itemize}
the LLC if the LLC does not continuously maintain a registered agent in Washington.85

Upon dissolution, a LLC distributes its assets first to creditors.86 Any remaining assets are distributed to the members; first, in return of their contributions to the capital of the LLC, and second, in the same proportion which the members share in distributions.87

C. Advantages in Comparison to Other Entities

1. LLCs vs. Corporations

Corporations and LLCs are both attractive business forms because they provide limited liability. However, the LLC has an advantage over the corporation because of its tax treatment by the Internal Revenue Service (IRS). Participants in a corporation are taxed twice. First, the corporation itself is taxed as an entity.88 Second, the shareholders must pay individual income tax on any distributions made by the corporation.89 In contrast, a LLC is not taxed as an entity.90 It is treated as an aggregate of its one or several members.91 Thus, any income to the LLC is not taxed until it is passed to the members, who are then taxed on an individual level.92

The key to the LLC’s tax treatment is found in an examination of what the IRS terms “corporate characteristics.”93 The corporate characteristics are: (1) free transferability of interests, (2) continuity of life, (3) centralization of management, and (4) limited liability for all of its participants.94 The IRS will tax a business on its income if that busi-

85. WAHS. REV. CODE § 25.15.280 (1994).
86. Id. § 25.15.300(1)(a).
87. Id.
92. Id.; I.R.C. § 301.
94. Rev. Rul. 88-76, 1988-2 C.B. 360. These factors were established as guidelines in the Supreme Court’s 1935 decision in Morrissey v. Commissioner, 296 U.S. 344 (1935). The Court identified a number of corporate characteristics: (1) associates in a joint enterprise; (2) a purpose to transact business and share its gains; (3) title to property held by the enterprise as an entity; (4) centralized management through representatives of the participants; (5) entity existence unaffected by the death of participants; (6) beneficial interests in the entity transferable by the participants without affecting the continuity of the enterprise; (7) the introduction of large number of participants; and (8) liability of participants limited to their investment in the enterprise. Id. at 356-59. For a more detailed discussion of the development of the characteristics for tax purposes, see Gasur, supra note 90, at 439-40. In addition, the IRS is not bound by a state’s LLC enabling
ness maintains more than two of these corporate characteristics. For example, if a LLC has centralized management and limited liability, and it does not have free transferability of interests and continuity of life, the IRS will tax the LLC's income only after it has passed through to its individual members. On the other hand, if a LLC has three of the four corporate characteristics, the IRS will treat it as an entity for tax purposes: the LLC's income will be taxed first as income to the LLC, and then the LLC's members will be taxed individually on any distributed profits.

A Washington LLC will always have the characteristic of limited liability. Thus, the LLC members must primarily be concerned with avoiding two of the remaining three characteristics: free transferability of interests, centralization of management, and continuity of life. The Washington LLC statute addresses the continuity of life characteristic by providing a default provision which mandates dissolution of the LLC within thirty years of the filing of its certificate of formation. Therefore, if the LLC does not opt out of the default provision, continuity of life is eliminated as an option, making it more predictable that the IRS will treat the LLC as an aggregate for tax purposes. If the LLC does opt out of the default provision, but still needs to avoid the characteristic of continuity of life, it must provide in the LLC agreement that death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the LLC. If one of those events causes dissolution, the IRS will probably conclude that the LLC does not have continuity of life. If the LLC does not have continuity of life, the LLC must avoid only one of the last two characteristics: free transferability of interest or centralization of management.

In addition to favorable tax treatment and limited liability, the LLC has other advantages over a corporation. For example, an LLC has the option of disbursing management equally to all members, like a general partnership, while maintaining the option of centralized management. However, because the LLC must avoid two of the four

statute. The IRS's examination is solely of the existence or non-existence of corporate characteristics. Treas. Reg. § 301.7701-1(c) (1994).


97. See supra notes 62-70 and accompanying text.

98. WASH. REV. CODE § 25.15.270 (1994). The statute requires dissolution by mandating dissolution within thirty years if no dissolution date is specified. In other words, the LLC could conceivably continue for longer than thirty years, but it would have to specify such a date of dissolution in its Articles, or have this statutory dissolution date imposed on it.


100. WASH. REV. CODE § 25.15.150 (1994).
corporate characteristics to maintain aggregate tax status, it may not be in the company's best interest to centralize management. For this reason, the LLC is probably a better option for smaller, closely held companies where partnership-style management is efficient and effective.\textsuperscript{101}

In some respects, the corporation has advantages over the LLC. For example, the corporation has continuity of life.\textsuperscript{102} Conversely, a Washington LLC cannot achieve continuity of life.\textsuperscript{103} This limitation is necessary, however, to prevent a Washington LLC from satisfying more than two of the IRS's corporate characteristics, and thereby losing its aggregate tax treatment.\textsuperscript{104}

Another advantage of a corporation is the corporation's free transferability of interests. Assuming that the shareholders have not agreed otherwise, a shareholder of a corporation may at any time assign his or her shares in the company.\textsuperscript{105} The assignee would then enjoy the same rights and privileges of the previous shareholder.\textsuperscript{106} In contrast, unless the LLC agreement provides otherwise, the members of the LLC can assign only their economic interests in the LLC.\textsuperscript{107} The assignee is not considered a member (which would entitle her to a vote and participation in management) without the unanimous approval of the remaining members.\textsuperscript{108}

In some cases, the corporation will be the better organizational choice for a business because of a need to utilize more than two of the four corporate characteristics. However, the LLC provides an additional organizational form with important benefits unavailable under the corporate form. Thus, the LLC gives businesses an additional choice and more flexibility in ordering their operations.

2. LLCs vs. S-Corporations

Although similar in many ways, LLCs have several distinct advantages to S-Corporations. An S-Corporation is a business entity that meets all the incorporation requirements of a state's incorporation statute, but makes a special election with the IRS.\textsuperscript{109} Thus, it combines

\textsuperscript{101} This situation can be alleviated by having a corporation as a member or manager.

\textsuperscript{102} See generally WASH. REV. CODE \textsection 23B.03.020 (1994). Typically, corporate dissolution must be authorized and is not automatic.

\textsuperscript{103} WASH. REV. CODE \textsection 25.15.270 (1994).

\textsuperscript{104} See supra notes 93-99 and accompanying text.

\textsuperscript{105} See generally WASH. REV. CODE \textsection 23B.06 (1994).

\textsuperscript{106} Id.

\textsuperscript{107} Id. \textsection 25.15.250.

\textsuperscript{108} Id.

\textsuperscript{109} See ROBERT HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 321 (1989).
limited liability with aggregate tax treatment allowed under Subchapter S of the tax code. However, to make this election and qualify for aggregate taxation, the S-Corporation is restricted in its choice of corporate characteristics. An S-Corporation cannot have more than thirty-five shareholders, all of whom must be individuals or estates. It can have as shareholders United States citizens and resident aliens, but cannot have as shareholders non-resident aliens. In addition, the S-Corporation cannot have more than one class of stock, or subsidiaries.

However, even when an S-Corporation satisfies these restrictions, it still faces the risk of corporate tax treatment if (1) its passive investment income exceeds twenty-five percent of the S-Corporation’s gross receipts, and (2) the corporation has subchapter C earnings and profits at the close of three consecutive taxable years. LLCs do not face this risk. Consequently, LLC tax treatment is more predictable.

In contrast to the S-Corporation, the LLC does not have restrictions on the maximum number or types of its members. Additionally, the LLC has more flexibility in capitalizing an enterprise because the LLC is allowed several classes of member interests. Finally, LLCs have fewer restrictions on stock transferability because they can transfer shares to corporations, trusts, or aliens without the risk of losing favorable tax treatment.

3. LLCs vs. Partnerships

A general partnership exposes all of its partners to personal liability for the debts and obligations of the partnership. A limited partnership provides limited liability to its limited partners, but requires at least one general partner who is exposed to personal liability. And although a limited partnership could achieve total limited liability by using a corporation as the general partner, the corporation would still

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110. Id. at 322; I.R.C. § 1361(b) (1988 & supp. 1989).
111. I.R.C. § 1361(b).
113. HAMILTON, supra note 109, at 322.
114. Passive investment income is that earned from business activities in which the taxpayer does not materially participate. I.R.C. § 469(c) (1988).
117. HAMILTON, supra note 109, at 322.
be taxed twice on its income. The LLC, in contrast, provides both limited liability and pass-through taxation.

In addition, except for specific statutorily protected activities, limited partners cannot participate in management without the threat of losing the protection of limited liability. In contrast, the LLC provides for limited liability for all of its members even if they participate in all aspects of management. The LLC also has the added option of centralized management. However, to avoid taxation as an entity, an LLC opting for centralized management must make certain that it does not have free transferability of interests and continuity of life.

Similarities between LLCs and partnerships include pass-through taxation, and potential use of losses as a tax shelter for income from other sources.

V. CONCLUSION: BENEFITS TO WASHINGTON STATE

Washington has taken a step towards attracting small business by passing the LLC Act. Because the LLC is tailor-made for small businesses, the LLC Act will prove to be beneficial to Washington State’s economy by encouraging both local and foreign investment. The Act ensures limited liability and can provide the desirable option of pass-through taxation for local businesses using this form. Thus, the availability of the LLC in this state will encourage local investment in the economy by those that might have otherwise been discouraged from investing.

In addition, the Act ensures limited liability and favorable tax classification to foreign LLCs desiring to do business within the state. Foreign investment will benefit in two areas. First, LLCs registered in other states can engage in business in Washington under the guarantee

120. Wash. Rev. Code § 25.10.190 (1994). If a limited partner participated generally in the management of the partnership, she would lose her limited liability. Id.
121. Id. § 25.15.155.
122. See supra text accompanying notes 93-99.
124. I.R.C. § 702(a) (1988). See Code sections 704, 465, and 469 for limitations on a partner’s allocated losses. I.R.C. §§ 465, 469, 704 (1988 & supp. 1990, 1992, 1993). Section 469 prevents a taxpayer who does not materially participate in the conduct of a trade or business from applying any losses sustained from the operation of that business to the taxpayer’s income from active business activities, including salary income, or investment income. I.R.C. § 469 (1988 & supp. 1993). Losses from passive activities may only be deducted from income from other passive activities, although losses disallowed may be carried forward and may be deducted from future passive income. Id. Thus, if the LLC opts for centralized management, those members who are not regularly involved in the daily operations of the company cannot deduct losses sustained by the LLC from their income from active business activities.
of limited liability for their members and managers. With the LLC Act, out-of-state foreign LLCs are assured that their state's recognition of limited liability will be honored in Washington. Second, the LLC Act places no restrictions on foreign ownership of an LLC. This is of particular interest to Washington given its connection with the Pacific Rim. Providing the LLC as an option will make it easier for off-shore companies to do business in Washington, as these entities now will enjoy the same amount of organizational flexibility in this state as they do in every other state with an LLC statute. This flexibility will create greater incentives for those foreign businesses to participate in Washington's economy.

Not only will the LLC statute create incentives for foreign companies to conduct business within the state, it will also attract foreign investors. Often, investors who are risk-averse have greater incentive to invest in local companies where their exposure to personal liability is decreased or eliminated. With the LLC statute, limited liability is guaranteed, so long as no abuse occurs. By eliminating the risk of personal liability, the statute could greatly impact the participation of foreign investors in the local economy.

In addition to encouraging investment, the LLC is also an attractive alternative for companies in the early stages of financing because LLCs do not have limitations on multiple classes of stock and number of shareholders. For example, as mentioned above, S-Corporations allow for only one class of stock and a maximum of thirty-five shareholders. Such a limitation could restrict the amount an S-Corporation can obtain for capitalization. Because the LLC form does not have such restrictions, LLC members have numerous options for designing methods for higher capitalization of the LLC.

By enacting the LLC Act, Washington has taken a step in the right direction: the LLC Act creates a safe harbor for LLCs doing business within the state, and provides much needed encouragement for small businesses to organize in Washington.