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Corporate Shell Games

LLPs, LLCs, and Responsibility for Mitigation Sites

Determining responsibility for a wetland mitigation site is not always a straight-forward process. A recent real-life example highlighted the need for wetlands regulators to understand corporate structure in dealing with the variety of legal entities that can assume responsibility for mitigation sites.

By Royal C. Gardner and Theresa Pulley Radwan

We expect wetland regulators to be Renaissance men and women. They are supposed to be well-versed in various sciences, such as hydrology, botany, soils, and biogeochemistry. They should have a full understanding of economics and business realities. It is also important that they be expert in the art of negotiation and mediation. Furthermore, wetland regulators must be knowledgeable in the law. Not only must they be familiar with the intricacies of the regulations that they administer, but they need to appreciate the differences and risks associated with different types of legal entities, including corporations, limited liability partnerships (LLPs), and limited liability companies (LLCs). A person who possesses this knowledge and skill would be akin to a chimera, the mythical beast that is a combination of a lion, snake, and goat. But like the chimera, such a wetland regulator is not found in nature.

A real-life wetland regulator recently called us to ask about LLCs and the corporate structure of a proposed wetland mitigation bank. In this regulator's experience, LLCs involved many rotating players: an LLC's owners would change from time to time, as would the individuals who had primary responsibility for the mitigation site. The wetland regulator provided us a complicated Officer's Certificate from a mitigation bank application on behalf of Mollusk Creek, LLC.[1] An excerpt of the Officer's Certificate, which referred to a traditional corporation (listing its officers), an LLP, and two LLCs, is reprinted on the next page (figure 1). The regulator wanted to know, in light of the Matryoshka-like quality of the entities listed in the Officer's Certificate, who was ultimately responsible for the mitigation site and whether the corporate structure was a cause for concern. The answer requires an understanding of the legal characteristics of LLPs and LLCs.

This article explains what LLPs and LLCs are, and why many mitigation bank operators opt for these business forms. We also walk through the Officer's Certificate to try to unravel which entity actually would be responsible for the mitigation bank site. Finally, we conclude with recommendations that wetland regulators should consider when evaluating mitigation proposals involving LLPs and LLCs, whether affiliated with a mitigation bank or not. While there is no particular reason to be worried about LLPs

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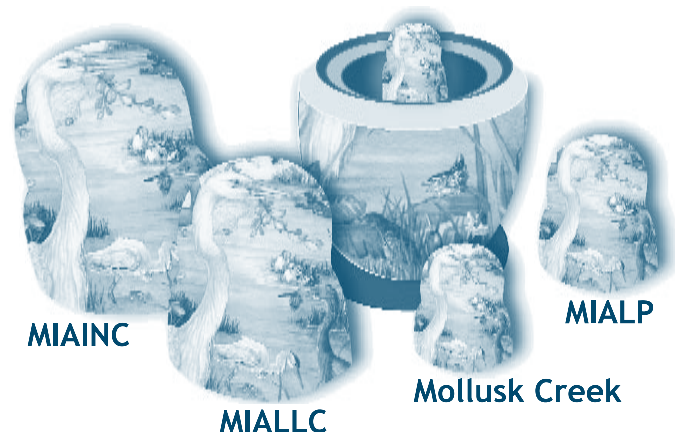

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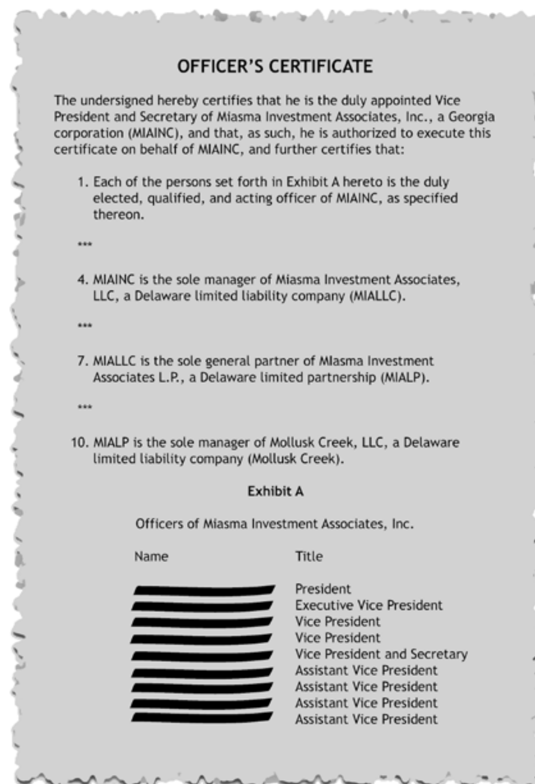
and LLCs, as compared to traditional corporations, regulators should consider requiring notice for any changes in the ownership and management of these entities. Regulators should also ensure that financial assurances such as letters of credit and performance bonds expressly cover the entity (whether LLP, LLC, or another form) responsible for the mitigation site.



OFFICER'S CERTIFICATE

The undersigned hereby certifies that he is the duly appointed Vice President and Secretary of Miasma Investment Associates, Inc., a Georgia corporation (MIAINC), and that, as such, he is authorized to execute this certificate on behalf of MIAINC, and further certifies that:

1. Each of the persons set forth in Exhibit A hereto is the duly elected, qualified, and acting officer of MIAINC, as specified thereon.

...

4. MIAINC is the sole manager of Miasma Investment Associates, LLC, a Delaware limited liability company (MIALLC).

...

7. MIALLC is the sole general partner of Miasma Investment Associates L.P., a Delaware limited partnership (MIALP).

...

10. MIALP is the sole manager of Mollusk Creek, LLC, a Delaware limited liability company (Mollusk Creek).

Exhibit A

Officers of Miasma Investment Associates, Inc.

Name	Title
[redacted]	President
[redacted]	Executive Vice President
[redacted]	Vice President
[redacted]	Vice President
[redacted]	Vice President and Secretary
[redacted]	Assistant Vice President
[redacted]	Assistant Vice President
[redacted]	Assistant Vice President
[redacted]	Assistant Vice President

Figure 1

A Brief Primer on Limited Liability Entities

Before the development of the modern corporation, businesses organized as sole proprietorships or partnerships. In this form, the business and owners were synonymous.[2] As a result, the owners of the business shared the same risks as the business itself.[3] If the business committed a tort or breached a contract, the owners shared responsibility and were personally liable to the victim of that action.[4] The modern corporation eliminated this shared responsibility, allowing the owners of a corporation to limit personal liability for actions taken by the corporation.[5] Unfortunately, this limited liability means that when the company dissolves or cannot pay its debt, there may be no way for those harmed by the company's actions to recover losses.[6] But this limited liability comes at a cost to the corporation and its owners as well. Because the corporation exists separately from its owners, it can be taxed as a separate entity. Thus, when choosing between a partnership or corporation, owners had a choice: operate as a partnership and risk personal liability for the wrongful acts of the business (figure 2), or incorporate and avoid that liability, but pay additional taxes (figure 3).[7]

In the past 30 years,[8] corporate law has undergone significant changes with the emergence of new limited liability entities—LLPs[9] and LLCs. Structurally, LLPs resemble partnerships, often with the owners of the company also serving as the management of the company; LLCs, on the other hand, resemble modern-day corporations, where the ownership of the company is separate from the management of the company. Both allow the owners and management of the company to enjoy limited liability for the debts of the company, as in a traditional corporate structure. But due in large part to two favorable tax treatment rulings by the Internal Revenue Service,[10] business owners no longer have to choose between limited liability and additional taxes. LLPs and LLCs allow business owners to enjoy limited liability *and* partnership taxation[11] benefits.[12] Not surprisingly, the popularity of these flexible corporate forms has soared.[13]

While business laws differ from state to state, the National Conference of Commissioners on Uniform State Laws (NCCUSL) has promulgated model laws for limited liability entities. While NCCUSL's Uniform Limited Partnership Act has been adopted in some form by almost every state,[14] its Uniform Limited Liability Company Act has only been adopted in a handful of states.[15] But even those states not adopting NCCUSL's recommended language have mirrored the primary limited liability and tax benefits included in the NCCUSL provisions.

To fully evaluate the risks of working with a limited liability entity, wetland regulators need to understand: the organization of the business and the limits of owner liability; how the business is managed; and whether the ownership and management of the company can be changed. Every corporation, LLP, and LLC offers limited liability to the entity's owners.[16] However, obtaining documents at the inception of, and during the relationship with, these businesses can provide insight into the risks associated with that limited liability.

Registration of the Business: Its Organization and Limits on Owner Liability

Regardless of the type of business, limited liability entities generally register with the state.[17] A wetland regulator may conduct searches and request copies of business filings directly from the relevant state agency (typically the Office of the Secretary of State) or may require that the business provide a state-certified copy of its filing documents.[18] Either way, these documents can help the regulator to make an informed decision about approving the business as a mitigation provider. The documents filed, in conjunction with the bylaws or other corporate documents, allow the regulator to determine whether the entity's owners share liability with the business itself. If not, as is likely the case, the regulator knows to consider only the financial health of the company, not relying upon the financial health of individual owners and managers of the company, when considering whether to approve a mitigation proposal.

Management of the Business: Owners as Managers and Limits on Manager Liability

One of the most important features of any business is its management. After all, if you can only rely on the resources of the

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Figure 2

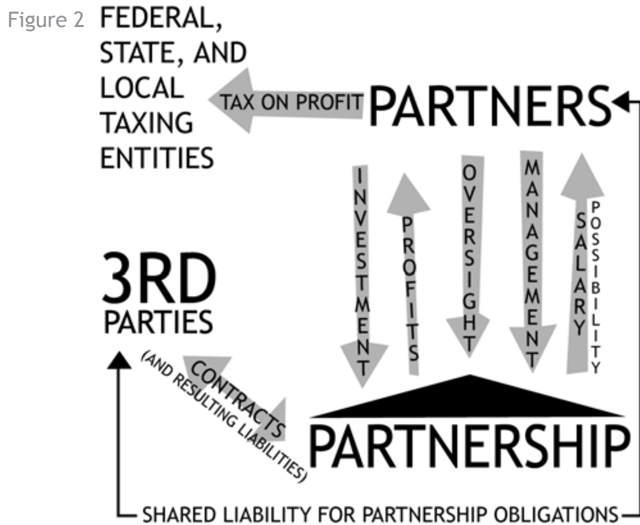

Figure 3

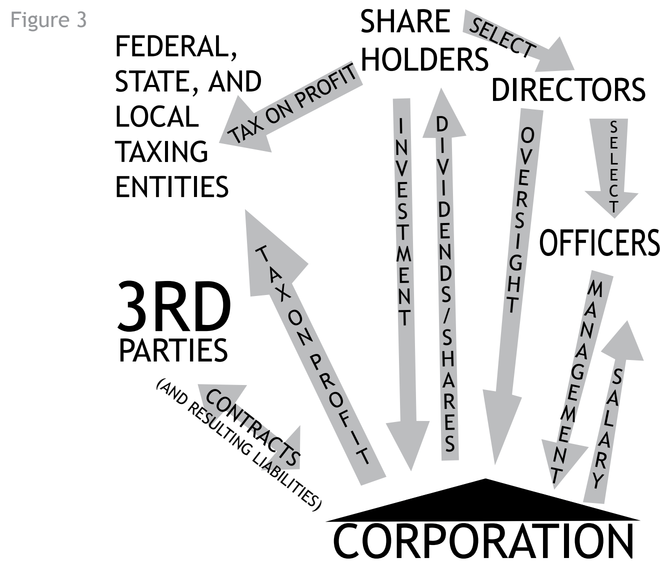

Figure 4

business to ensure completion of its commitments or payment for failure to meet those obligations, the individuals or entities controlling the business' resources become critical to the success of the relationship.

This is an area in which the newer limited liability entities—the LLP and LLC—may differ substantially from the traditional corporation. A traditional corporation segregates ownership of the business from management of the business.[19] The shareholders (owners) of the corporation vote for the directors of the corporation who, in turn, select the officers of the corporation.[20] Beyond selecting the directors and voting on major changes to the corporation, the shareholders have limited input in the daily affairs of the corporation.[21] LLCs may operate the same way, and are then called "manager-managed" (figure 4).[22] But they may also be "member-managed," where the members (owners) of the company all participate in the daily operation of the business (figure 5).[23]

The liability associated with an LLP may differ slightly. Ordinarily, general partners manage the business of an LLP[24] and are personally liable for the obligations associated with the business. Limited partners have no management function and no personal liability for these business obligations. Initially, LLPs were required to have a general partner with unlimited liability (figure 6), but some states now permit *all* partners to enjoy limited liability. Such entities are often called "limited liability limited partnerships" (LLLPs). In an LLLP, the limited partners who are engaged in the management of the business are not personally liable for the business' obligations (figure 7).

Regardless of who manages the business, however, the members and managers are not personally liable for the debts and obligations of the LLC,[25] LLP,[26] LLLP,[27] or corporation[28] unless the incorporation documents require such liability or the member or manager agrees to such liability (including by serving as a "general" partner of an LLP).[29] Thus, the starting presumption for a wetland regulator should be that neither the managers nor members in these businesses have assumed personal liability for the business' obligations.

Transferability of Ownership Interests

In a traditional corporation, ownership interests are generally fungible. Shares in the corporation may be freely traded. This same free transferability *may* exist in the newer limited liability entities, but by default does not. In LLCs, for example, the ownership interest itself cannot be transferred. Rather, it is the benefit (the profit) from that interest that can be transferred.[30] However, the business can provide for the free transferability of the complete ownership interest if desired, thus allowing the owners (who may also be participating in the management of the business) to transfer that interest to others without restriction.[31] In the context of a mitigation bank, this free transferability can result in a change of the management of the mitigation banking company. Thus, wetland regulators should review the incorporation documents (articles of incorporation and bylaws in the case of LLCs and operating agreements in the case of LLPs) to understand whether the

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owners may freely transfer that ownership interest in assessing the risk of working with that mitigation provider.

In addition to reviewing documents to determine the transferability of ownership interests, the regulator should consider whether specific notice provisions[32] or limitations on transfer of ownership or management interests[33] should be incorporated into the mitigation banking agreement. It is not unusual to have such provisions in various credit arrangements, and a variety of forms exist outlining these arrangements.

With this background in mind, let us turn to the particulars of the proposed Mollusk Creek mitigation bank.

Who Is Really Responsible for the Mollusk Creek Mitigation Bank Site?

Each of the entities and the individuals listed in the Officer's Certificate is interconnected, from Mollusk Creek, LLC, at the end, up through Miasma Investment Associates, Inc., and its officers (figure 8).

It is likely that only Mollusk Creek, LLC, would be responsible for the obligations associated with the mitigation bank. Because Mollusk Creek is an LLC, its management and owners are not personally liable for Mollusk Creek's obligations. Thus, Miasma Investment Associates, L.P., Mollusk Creek's manager, is not liable for Mollusk Creek's obligations. Indeed, although each of the businesses outlined in the Officer's Certificate is interconnected, each is also formed as a limited liability entity. Thus, absent voluntarily assuming liability for the others' debts, or actions that allow piercing of the limited liability shield, none of the companies is liable for the others' debts or obligations. The one exception to this limited liability may be Miasma Investment Associates, LLC, which, as the *general* partner of Miasma Investment Associates, L.P., likely assumes liability for the L.P.'s obligations. However, this assumption of liability does not extend to the debts and obligations of Mollusk Creek because Miasma Investment Associates, L.P., has not assumed liability for Mollusk Creek's obligations.

One wonders what the point of this Officer's Certificate is. If the goal is obfuscation, the mission may have been achieved. The document lists a host of entities and even includes the names of the individual officers of Miasma Investment Associates, Inc., all of which are largely irrelevant. Perhaps this information was provided to demonstrate to the wetland regulator who would, at least initially, be managing the mitigation bank site. Ultimately, however, the only entity responsible for the site is Mollusk Creek, LLC.

Concluding Thoughts and Recommendations

First, wetland regulators should not be alarmed by the use of LLPs and LLCs. Mitigation providers likely choose these business entities over a traditional corporation to secure tax benefits, not to further avoid legal liability for wetland mitigation sites. Nevertheless, wetland regulators should be aware that LLPs and LLCs, like a traditional corporation, are by definition limited liability entities. The individuals that manage the mitigation site and the entities upstream (whether managers and/or owners and mem-

Figure 5

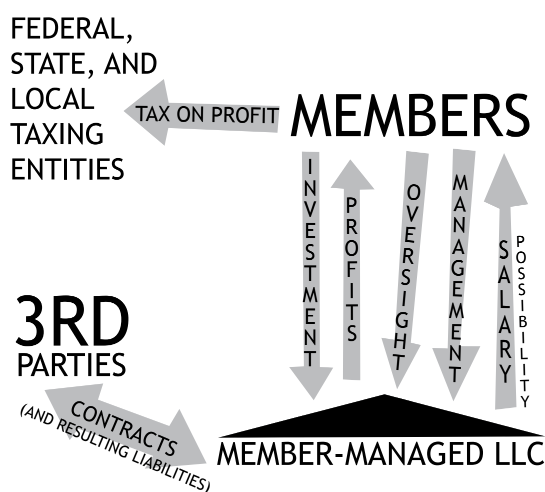


Figure 6

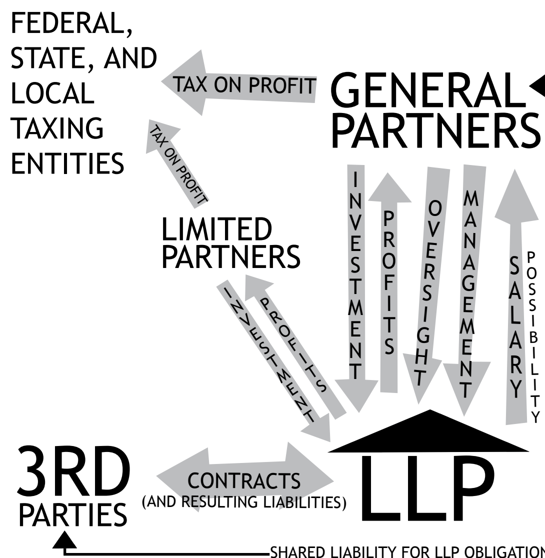
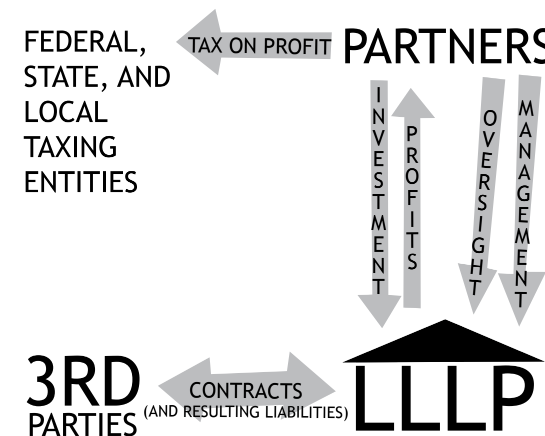


Figure 7



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Resources

Secretary of State Corporation and Business Entity Search Page, **www.secstates.com**, *offers links to information on any U.S. corporation or business entity through the Secretary of State website of the state or territory where the entity is registered.*

Business.gov *is the official business link to the U.S. government. Business Incorporation,* **www.business.gov/register/incorporation**, *provides information about sole proprietorships, partnerships, corporations, LLCs, non-profit organizations, and cooperatives.*

U.S. Small Business Administration, Small Business Planner, **www.sba.gov/smallbusinessplanner/start/chooseastructure/START_FORMS_OWNERSHIP.html**, *offers information to business owners about the characteristics of different business forms.*

Internal Revenue Service, Business Structures, **www.irs.gov/businesses/small/article/0,,id=98359,00.html**, *provides tax information about sole proprietorships, partnerships, corporations, and LLCs.*

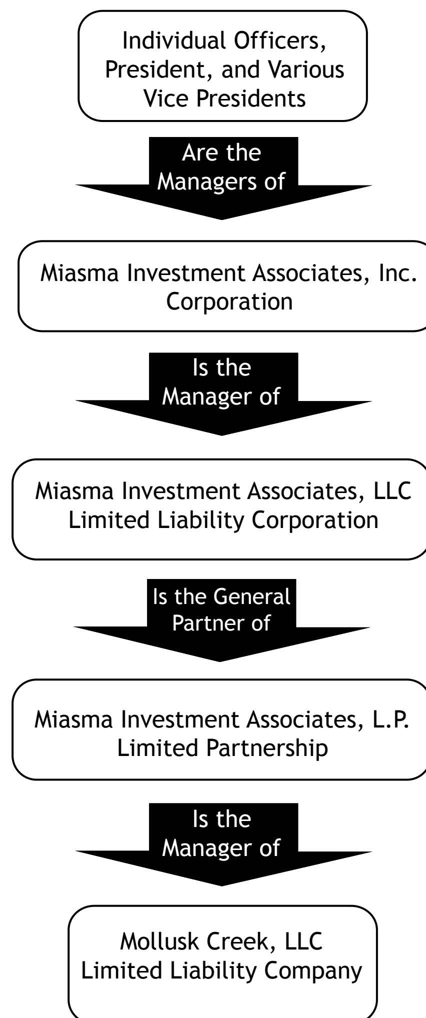
bers) are not on the hook if problems develop at the mitigation site.

Accordingly, a wetland regulator should know at the outset who (which entity) is legally responsible for the mitigation site. We suggest requiring that the mitigation bank applicant provide incorporation and state filing documents, as well as relevant bylaws and operating agreements that outline the entity's ownership, its management structure, and the transferability of ownership. In addition to having legal counsel review these documents, the regulator should require the applicant to certify who is legally responsible for the debts and obligations of the mitigation bank. It may very well be that only an LLC or LLP is responsible, which in and of itself is not problematic. But this matter should be clear before the mitigation bank is approved.

Once it is clear who would have responsibility for the mitigation site, the wetland regulator should ensure that the entity is financially capable of performing its required tasks. Typically, a regulator will require that the entity produce financial assurances, such as performance bonds or letters of credit. A key point is that these financial assurances must be related to the entity that is legally responsible for the mitigation site. Turning back to the Mollusk Creek scenario, it is Mollusk Creek, LLC, that must obtain the financial assurances. If the performance bonds or letters of credit are issued for Mollusk Creek's manager, Miasma Investment Associates, L.P., it is uncertain whether the regulator could ever draw on these resources. As manager, Miasma Investment Associates, L.P., is not responsible for the debts and obligations of Mollusk Creek. It is doubtful that a bonding company or bank would pay out without a protracted fight.

When a wetland regulator reviews a mitigation bank proposal, he or she does so mindful of the individuals involved in the project. What is the track record of these people? Have they managed successful mitigation projects in the past? Are they trustworthy? Yet, the wetland regulator should not forget that, ultimately, it is a remorseless entity (an LLC or LLP) that is responsible for the mitigation project. The individuals may come and go, but the legal entity will persist. The management and ownership of limited liability entities may change over time, and the individuals, in which the regulator had confidence, may fade from the scene. To avoid such surprises (or at least to be apprised of them in a timely fashion), we recommend that regulators consider including in mitigation bank agreements a provision that requires notice of changes in management or ownership of the mitigation bank, as a creditor would do. Regulators might also consider a provision that restricts the release and/or sale of additional credits until the agency has had an opportunity to review and consider such management or ownership changes.

Unraveling the Officer's Certificate



Finally, we note that although this discussion about limited liability entities focused on mitigation banks, the points raised are equally valid with respect to all mitigation providers, such as permittees and in-lieu fee programs. ■

Endnotes

1. We have altered the names of the entities involved; however, the relationships between the entities remain as submitted to the regulator.
2. John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 Geo. Wash. L. Rev. 1, 5 (1996).
3. Thomas E. Rutledge, *Limited Liability (or Not): Reflections on the Holy Grail*, 51 S.D. L. Rev. 417, 419–20 (2006).
4. Matheson & Olson, *supra* note 2, at 5.
5. Rutledge, *supra* note 3, at 425 (citing the Model Business Corporation Act §6.22). Limited liability has its own limits, however. For a discussion of the limits to limited liability for owners, see *id.* at 430–49.
6. Matheson & Olson, *supra* note 2, at 8. For a discussion focusing on mitigation banks, see Royal C. Gardner & Theresa Pulley Radwan,

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What Happens When a Wetland Mitigation Bank Goes Bankrupt?, 35 ELR 10590 (2005) (abridged and updated version published in 28 Nat'l. Wetlands Newsl. 1 (July/Aug. 2006)).
7. Matheson & Olson, *supra* note 2, at 10–11.
8. Wyoming passed the country's first limited liability company statute in 1977. Unif. Ltd. Liab. Co. Act Prefatory Note (amended 2006), 6B U.L.A. 546 (2008).
9. Limited liability partnerships, followed by limited liability limited partnerships, arose primarily in the early 1990s, when Texas, Louisiana, Delaware, Washington, D.C., and North Carolina adopted early LLP statutes. These early statutes focused on businesses such as law firms that were not entitled to use the limited liability company statutes. Rutledge, *supra* note 3, at 423.
10. Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context*, 23 Quinnipiac L. Rev. 61, 65 (2004). Together, these rulings allow an LLC to easily choose to be treated as a partnership for tax purposes, rather than as a corporation. *Id.*
11. Partnerships enjoy "pass-through" taxation. The partnership itself does not pay taxes; rather, the partnership earnings are taxed as income to the partners themselves. Louis G. Herring et al., *Limited Liability Companies: Legal Aspects of Organization, Operation, and Dissolution*, Corp. Prac. Series (BNA) No. 67-2d, at §II (July 2008).
12. *See* Unif. Ltd. Liab. Co. Act Prefatory Note, 6B U.L.A. 546 (stating that "[t]he allure of the limited liability company is its unique ability to bring together in a single business organization the best features of all other business forms—properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership"). Citations herein are to the 1996 version of the Uniform Limited Liability Company Act.
13. Szto, *supra* note 10, at 62 (citing study finding 2300% increase in number of new LLC filings from 1992 through 1996).
14. Fifteen states adopted the 2001 version of the Uniform Limited Partnership Act. However, earlier versions of the act had been adopted by 49 of the states. Nat'l Conference of Comm'rs on Unif. State Laws, A Few Facts About the Uniform Limited Partnership Act (2001), http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ulpa.asp (last visited Sept. 5, 2009).
15. Conference of Comm'rs on Unif. State Laws, A Few Facts About the Uniform Limited Liability Company Act (2006), http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ullca06.asp (last visited Sept. 5, 2009) (noting adoption of 2006 act by Idaho and Illinois); *but see* Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act* 1, Univ. Illinois Law & Economics Research Paper No. LE07-027 (July 29, 2007), *available at* SSRN: http://ssrn.com/abstract=1003805 (indicating adoption by eight states, and noting that while most states have adopted LLC statutes, the states have created their own statutes rather than using the NCCUSL proposed format).
16. *See* Unif. Ltd. Liab. Co. Act §303, 6B U.L.A. 587; Model Bus. Corp. Act §6.22(b) (1979); Unif. Ltd. P'ship. Act §303 (amended 2001), 6A U.L.A. 418 (2008). However, the Uniform Limited Partnership Act provides for two types of partners—the limited partner and the general partner. While "[a] limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner," Unif. Ltd. P'ship. Act §303, 6A U.L.A. 418, a general partner is "liable jointly and severally for all obligations of the limited partnership unless otherwise agreed by the claimant or provided by law." Unif. Ltd. P'ship. Act §404(a), 6A U.L.A. 432. Thus, in a limited liability partnership, there may be a general partner with unlimited personally liability for the partnership's actions.
17. *See* Unif. Ltd. Liab. Co. Act §202, 6B U.L.A. 574; Unif. Ltd. P'ship. Act §201, 6A U.L.A. 392; Model Bus. Corp. Act §2.02. The American Bar Association's Committee on Corporate Laws of the Section of Business Law drafted the Model Business Corporation Act, now in its third edition.
18. *See* Unif. Ltd. Liab. Co. Act §208(a), 6B U.L.A. 581 (stating that "[a] person may request the [State] to furnish a certificate of existence for a limited liability company or a certificate of authorization for a foreign limited liability company"); Unif. Ltd. P'ship. Act §209(a), 6A U.L.A. 407 (stating that "[t]he [State], upon request and payment of the requisite fee, shall furnish a certificate of existence for a limited partnership").
19. Model Bus. Corp. Act §§8.01(b), 8.40.
20. *Id.* at §§8.03(c), 8.40(b).
21. Thomas E. Rutledge, *External Entities and Internal Aggregates: A Deconstructionist Conundrum*, 42 Suffolk L. Rev. 655, 667 (2009).
22. Unif. Ltd. Liab. Co. Act §§301 (6B U.L.A. 585), 404(b) (6B U.L.A. 591).
23. *Id.* at § 404(a), 6B U.L.A. 591.
24. General partners of a limited liability partnership share management responsibilities equally. Unif. Ltd. P'ship. Act §406(a), 6A U.L.A. 434.
25. Unif. Ltd. Liab. Co. Act §303(a), 6B U.L.A. 587.
26. Unif. Ltd. P'ship. Act §303, 6A U.L.A. 418.
27. *Id.* at §404(c), 6A U.L.A. 432.
28. Model Bus. Corp. Act (revised) §§8.30, 8.31, 8.40.
29. Unif. Ltd. Liab. Co. Act §303(c), 6B U.L.A. 587.
30. Unif. Ltd. P'ship. Act §§102(22) (6A U.L.A. 360), 701 (6A U.L.A. 461), 702 (6A U.L.A. 461–462); Unif. Ltd. Liab. Co. Act §502(a), 6B U.L.A. 602–603. Both Uniform Acts contain language in the comments regarding this transferability of economic interests; the 2006 Uniform Limited Liability Company Act language, for example, provides that:

> A member's rights in a limited liability company are bifurcated into economic rights (the transferable interest) and governance rights (including management rights, consent rights, rights to information, rights to seek judicial intervention). Unless the operating agreement otherwise provides, a member acting without the consent of all other members lacks both the power and the right to: (i) bestow membership on a non-member, Section 401(d); or (ii) transfer to a non-member anything other than some or all of the member's transferable interest. Section 502(a)(3). However, consistent with current law, a member may transfer governance rights to another member without obtaining consent from the other members. Thus, this Act does not itself protect members from control shifts that result from transfers among members (as distinguished from transfers to non-members who seek thereby to become members).

Unif. Ltd. Liab. Co. Act (amended 2006) §502, cmt., 6B U.L.A. 497 (2008).
31. Unif. Ltd. P'ship. Act §110(b), 6A U.L.A. 378–379.
32. For example, one form suggests the following notice provision for a security agreement: "Debtor shall give Secured Party at least 45 days prior written notice of any change in Debtor's identity, name, location, form of business organization, ownership, and additional business locations." William Meade Fletcher, *Inventory Security Agreement With Power of Attorney,* 3A Fletcher Corp. Forms Ann. §2807.10 (4th ed. 2009). While this provision does not provide the creditor the ability to prevent the transfer of ownership of the debtor, it allows the creditor to take other protective actions in light of the change of ownership, as permitted by the credit agreement. Elsewhere, the agreement allows the creditor to declare a default of the security agreement if it "in good faith, deem[s] itself insecure with respect to any of the Collateral or repayment of any of the amounts described." *Id.* Combining these two provisions, if the change in ownership of the debtor provides cause for the creditor to feel insecure about repayment of the debt owed, the creditor can declare default and terminate the relationship. While good faith and insecurity are vague terms, and can certainly be the subject of contentious litigation, the notice of change in ownership has provided a potential remedy to the creditor.
33. Another form for a security agreement suggests a provision for preventing a turnover in management or ownership of the debtor while the creditor is foregoing collection efforts on the debt: "During the Forebearance Period, there shall be no change of management or other change of control of any Debtor, including any notice of default that may lead to sale of the capital stock of any Debtor, or any disposition of a material amount of the assets of any Debtor outside the ordinary course of business." Lawrence R. Ahern, III, *Waiver, Modification, and Security Agreement*, 14B West's Legal Forms: Commercial Transactions §29.4 (4th ed. 2009). Together with a later provision that "fail[ure] to comply in a timely manner with any of the Conditions of Forbearance," *id.*, constitutes a default allowing termination of the relationship, this provision forbids changes in ownership and/or management, and provides a remedy to deal with non-approved changes.

Resources

U.S. Environmental Protection Agency, Compensatory Mitigation, **www.epa.gov/wetlandsmitigation**, *provides detailed background on the 2008 Clean Water Act Section 404 Compensatory Mitigation Rule.*

U.S. Environmental Protection Agency, Mitigation Rule Familiarization Workshops, **www.epa.gov/owow/wetlands/wetlandsmitigation/workshops.html**, *provides information and training resources regarding the implementation of the 2008 Clean Water Act Section 404 Compensatory Mitigation Rule.*

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