

ARE BUSINESS ENTITIES A VIABLE OPTION?

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I. TYPES OF ILLINOIS BUSINESS ENTITIES

A. SOLE PROPRIETORSHIPS

The sole proprietorship is the simplest form of doing business and involves neither an agreement nor the creation of a separate legal entity. Under the common law--there is no specific statute--sole proprietorships arise whenever a natural person goes into business for himself or herself as the sole owner of that business. That business may be largely conducted by employees or other agents of the owner, of course, but it is owned and operated (or, for that matter, terminated) at the sole discretion of a single individual who is its only owner. Because of these characteristics, and in particular the absence of any separate legal identity of the business from its owner, sole proprietorships confer no asset protection whatsoever upon their owners, who are thus personally liable for all their obligations. Not only the owners' business assets but also all their non-exempt personal assets may be subject to the claims of any creditors of the business.

Under the Internal Revenue Code, a sole proprietorship is disregarded for income tax purposes and treated as the same taxpayer as the owner. Similarly, a sole proprietor is treated as his or her own employee for purposes of the employment taxes on self-employment income and the establishment of Keogh plans. Sole proprietors may also qualify as their own employees under state worker's compensation and unemployment insurance statutes.

Whenever the business name of a sole proprietorship differs from the owner's full legal name, the owner must make an Assumed Name filing with the county recorder's office.

Sole proprietors must also obtain any necessary professional or business licenses for their respective businesses and Federal Employer Identification Numbers (FEINs) if they pay any wages to employees.

B. GENERAL PARTNERSHIPS

General Partnerships are separate legal entities that consist of “an association of two or more persons to carry on as co-owners a business for profit formed under [the Uniform Partnership Act (1997)], predecessor laws, or comparable laws of another jurisdiction.” 805 ILCS 206/101(f). They are the easiest to form of all the separate legal entities because they can

arise simply from the fact of such an association, based on a partnership agreement, for such co-ownership of a business for profit. That Agreement may be “written, oral, or implied” (805 ILCS 206/101(g)) and will suffice to create a partnership “whether or not the persons intend to form a partnership” (805 ILCS 206/202(a)). Even if the partnership agreement only covers that single basic point, a valid general partnership is thereby established: the statute will supply all the other terms through its comprehensive “default” provisions, i.e., provisions that automatically operate in the absence of a partnership agreement to the contrary.

Although general partnerships are separate legal entities “distinct from their partners” (805 ILCS 206/201(a)), they have the potential to create personal liabilities for each of the partners going far beyond even the unlimited personal liabilities of sole proprietors. For, according to Section 301 of the statute:

“Each partner is an agent of the partnership for purposes of its business. An act of a partner... binds the partnership, unless the partner had no authority to act for the partnership in the particular matter and the person with whom the partner was dealing knew or had received notification that the partner lacked authority.”
(805 ILCS 206/301 (1))

According to Section 305:

“A partnership is liable for loss or injury... to [any] person...as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or with authority of the partnership.”
(805 ILCS 206/305 (a))

And, according to Section 306(a):

“Except as otherwise provided in subsections (b) and (c) of this Section, all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.”
(805 ILCS 206/306 (a))(emphasis supplied)

Subsection (b) of the latter Section of the Act merely excuses a partner from personal liability with respect to partnership obligations incurred before that person became a partner.

Subsection (c) states the important exception for general partnerships that elect to become limited liability partnerships, discussed below.

General partners' personal assets as well as their partnership business assets are thus at risk without limit for any debts incurred or “wrongful acts” performed by any of their other partners while engaged in the partnership's business. What is more, every general partner possess the unwaivable power to dissociate from the partnership at any time by express will. 805 ILCS 206/103 (b)(5); 805 ILCS 206/602 (a). Absent a specific partnership agreement to the contrary, such a voluntary withdrawal automatically dissolves the partnership in the case of any “partnership at will” (which is any partnership except one for a definite term or particular undertaking) and requires the winding up of its business under Article 8 of the Act.

Also, again in the absence of a specific partnership agreement to the contrary, every dissociation of a partner that does not lead to a partnership dissolution, whether through voluntary withdrawal or a host of other adverse personal circumstances such as death, disability, or bankruptcy as set forth in Section 601, automatically requires the partnership to purchase the dissociated partner's interest for cash at a price equal to the greater of the liquidation value or the going concern value of the business without the dissociated partner. 805 ILCS 206/701. (Provable damages, if any, for “wrongful” dissociation, however, are offset against this compulsory buyout price.) Thus, a continuing general partner's interest in the partnership may be at risk not only because of what another partner does in the conduct of the partnership business, but also because of personal misfortunes that befall another partner. Additionally, the larger the dissociated partner's relative interest, the greater the likelihood that the required cash buyout will jeopardize the finances and prospects of the partnership, and hence reduce the worth of all the remaining partners' respective interests in it.

Some of these asset-protection risks of a general partnership can be reduced by the use of other entities--in particular, limited liability entities--as the general partners. (There is no requirement that partners must be natural persons.) Some of the risks can also, as has been seen, be reduced by specific contrary provisions of a partnership agreement. However, there are so many potentially problematical default provisions in the Uniform Partnership Act that the above-mentioned ease of forming a general partnership may properly be regarded as a trap for the unwary. Among the other default provisions of that statute (as well as the Limited Liability Company Act, it should be emphasized) that require revisions in most cases are the equal sharing of all profits among all partners and of all decision making authority by a majority of all partners, regardless of their relative contributions to the business. In sum, a general partnership may sometimes prove to be extremely successful and profitable for its partners, and in a case

where all the partners are contributing services provides the flexibility of compensating them for those services by draws against partnership profits as opposed to guaranteed payments under I.R.C. Section 707(c). But as a means of doing business with co-owners, it is incontestably the worst of all in terms of asset protection.

C. LIMITED LIABILITY PARTNERSHIPS

As of August 11, 1994, Illinois began allowing existing general partnerships to elect to become limited liability partnerships by registering as such with the Secretary of State. At first, the asset protection of this election was extremely limited because it merely shielded a partner from various forms of vicarious professional malpractice liability for the actions of other partners and employees of the partnership. However, since the enactment of the Uniform Partnership Act (1997), there has been much broader liability protection:

“An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner.”

(805 ILCS 206/306(c))

The partners of Illinois general partnerships formed after 2003 that elect limited liability partnership status automatically receive this greatly enhanced asset protection, subject to the applicable licensing rules that regulate professions. The partners of Illinois general partnerships formed before 2003 must, however, prior to 2008 (when all general partnerships must be brought under the new Act), first amend their partnership agreements to subject them to the new Act and then register them as limited liability partnerships in order to receive this same sweeping new form of asset protection.¹

Illinois attorneys--to take merely one example of a regulated profession--have been permitted to practice in limited liability partnerships since July 1, 2003, pursuant to amended Illinois Supreme Court Rule 721 and the newly added Rule 722. Their limited liability partnerships must however, maintain at least minimally adequate professional liability insurance

¹ For sake of brevity, the present discussion will not deal with the differences between the previous Uniform Partnership Act and the current version, i.e., the Uniform Partnership Act (1997). Nor will it deal with the differences between the previous limited partnership statute (the Revised Uniform Limited Partnership Act) and the current one (the Uniform Limited Partnership Act). However, in both cases the previous statutes may continue to apply to partnerships that were formed prior to the respective applicable mandatory effective dates and do not elect to be governed by the respective new statutes, until the end of 2007.

or else other proof of financial responsibility, in the amount of at least \$100,000 per claim and \$250,000 in the aggregate multiplied by the number of attorneys. Supreme Court Rule 722(b)(1). Also, they themselves must remain personally liable for any professional malpractice of their own or of any other persons under their direct supervision and control. Supreme Court Rule 722(c).

The initial registration of a partnership as a limited liability partnership is effective for a period of one year after the later of the filing date of the initial Statement of Qualification with the Secretary of State or the effective date specified in that statement and the payment of the required filing fee. Limited liability partnership status remains effective during that period regardless of changes in the partnership unless the partnership voluntarily withdraws its registration. 805 ILCS 206/1001(e). Thereafter, annual renewal statements with the required filing fee must be filed in order to maintain the limited liability partnership's status.

Although limited liability partnerships are certainly a great improvement in terms of asset protection over general partnerships that have not so registered, they share with general partnerships at least the following important asset protection risk. All the partners' business assets--all their investments and their present and future benefits from the firm--remain fully subject to any liabilities created by the other partners or the firm's employees in the conduct of the firm's business. Every partner is an agent of the entire firm with apparent authority (under the Uniform Partnership Act's default rules) to act for the entire firm. Moreover, again under the Act's default rules, partners who voluntarily withdraw from the partnership can thereby cause dissolution of the partnership. And, even if their "dissociation," whether voluntary or not, does not lead to a dissolution, it can impose a potentially very burdensome immediate cash buyout obligation upon the firm in the amount of the greater of the dissociating partners' shares of the liquidation value or of the going concern value of the firm.

General partners also owe strict fiduciary duties toward the other partners and the firm, which various potential outside investors in the business might find to be intolerable. The default rules requiring equal sharing of all profits and control according to the number of partners, not the amount of their contributions, except as specifically modified by the partnership agreement, are also an obvious impediment to outside investment. Without outside investment, the general partners are necessarily required to put and leave more of their own capital at risk in the partnership than they would if the partnership could attract such investors.

For these reasons, from an asset protection standpoint, even limited liability partnerships, with their express statutory protection from personal liability, are inferior to limited partnerships and limited liability limited partnerships. Only if the partners affirmatively desire to spread substantial decision-making authority among the partners, to preserve substantial fiduciary duties among the partners, and to run the partnership with substantial outside equity investment, would they be inclined to prefer a limited liability partnership, not even to speak of a general partnership, over a limited partnership or limited liability limited partnership.

D-E. LIMITED PARTNERSHIPS AND LIMITED LIABILITY LIMITED PARTNERSHIPS

The two formerly significant asset-protection disadvantages of limited partnerships have recently been eliminated. First, under the Uniform Limited Partnership Act (2001), which became effective on January 1, 2005, and will entirely replace the former Revised Uniform Limited Partnership Act as to preexisting limited partnerships as of January 1, 2008, limited partners are no longer in danger of losing their express statutory protection from personal liability if they participate in the management and control of the limited partnership. 805 ILCS 215/303. Second, it is now possible under the same statute for the general partners of limited partnerships to receive the same statutory protection from personal liability as do the limited partners and the general partners of registered limited liability partnerships, merely by causing those limited partnerships to file a statement in their respective Certificated of Limited Partnership that they elect to become limited liability limited partnerships. 805 ILCS 215/201 (a)(4); 805 ILCS 215/404(c).

It remains desirable for asset protection purposes for the general partners of all limited partnerships and limited liability limited partnerships to be limited liability entities. This is essential to avoid possible personal liability in the case of a general partner of a limited partnership, and it provides important back-up asset protection in the case of general partners of limited liability limited partnerships. The use of a limited liability entity general partner--or even better, two of them--also reduces the chance that a limited partnership or limited liability limited partnership might be dissolved because of the dissociation of a general partner. 805 ILCS 215/801. A corporate general partner, for example, would never die or become disabled, and if there were two, even the withdrawal of one of them would not (even as a default rule) cause the dissolution of the partnership unless within 90 days after the dissociation of on the

general partners a majority in interest of the remaining partners affirmatively consented to the partnership's dissolution. Id.

By centralizing the control of and apparent authority to act for a partnership in only one or two general partners, by separating the owners' investment returns from any required contribution of services by them, and by facilitating the transfer of their economic interests, limited partnerships and limited liability limited partnerships obviously lend themselves to the involvement of outside equity investors. They thus reduce the individual contributions of capital that the general partners and each of the other co-owners of the enterprise must place at risk in order for it to succeed. For their limited partners, these entities now offer the same high degree of asset protection long enjoyed by passive investors in corporate stock.

Like corporations, limited partnerships and limited liability limited partnerships also avoid a little-noticed asset protection risk of limited liability companies and series limited liability companies. This is the “default rule” for both of the latter that:

“A limited liability company shall purchase [for cash] the distributional interest of [any] member for its fair value determined as of the date of the member's dissociation if the member's dissociation does not result in a dissolution and winding up of the company's business under Section 35-1.”

(805 ILCS 180/35-60)

By contrast, according to the Uniform Limited Partnership Act (1997):

“A person does not have a right to receive [any] distribution on account of dissociation.”

(805 ILCS 215/505)

All partners' investments are thus locked into a limited partnership or limited liability limited partnership until its termination except to the extent that the partnership agreement specifically lets them out. Limited liability companies' members, on the other hand, may require those companies (on pain of dissolution for nonperformance) to buy them all out for cash upon dissociation except to the extent that the operating agreement specifically precludes that right. This marked difference in the respective default rules, it is submitted, makes limited liability partnerships, and especially those with multiple corporate general partners, more completely protective of all their owners' assets than are limited liability companies. The greater current

popularity of LLCs over limited liability limited partnerships as asset protection devices for businesses with multiple owners is at least in part the result of widespread misunderstanding.

F. LIMITED LIABILITY COMPANIES

Illinois' Limited Liability Company Act (805 ILCS 180/1 et seq.) became effective on January 1, 1994. From an asset-protection standpoint alone, apart from tax considerations, limited liability companies (“LLCs”) at that time provided even greater benefits than limited partnerships, not to speak of general partnerships. For, as has been seen, limited partners then could lose their liability protection if they participated to any extent in the management of the limited partnership, and general partners then were fully personally liable for all limited partnership obligations.

All members and even the managers of limited liability companies also then had two other important asset protection advantages over the directors and officers of business corporations: first, they were expressly protected by the statute against personal liability (beyond the extent of their investment in the respective LLCs) if they acted solely as such members and managers; second, they could themselves be limited liability entities. Directors and officers of business corporations, by contrast, could only look to the common law for protection, and were required to be individuals. In addition, the LLC statute liberalized the internal operating procedures necessary to protect against the loss of liability by providing that:

“The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.”

(805 ILCS 180/10-10(c))

Limited liability partnerships and, since 2005, limited liability limited partnerships have since obtained the statutory right to all these same protections except the last. It is arguable that the last protection itself can create a trap for the unwary by encouraging such supposed “informalities”--actually, major substantive defects--as the undercapitalization of the entity and the commingling of entity and personal assets (see the following discussion of State Law Requirements for Limited Liability). Nevertheless, by permitting the members and managers of an LLC, even a manager-managed LLC, to work together in carrying on the LLC's business without fear of personal liability, the LLC as an asset-protection device was at one point years ahead of the others' time.

Even now, LLCs have this one remaining theoretical asset-protection advantage over limited liability limited partnerships: they are not subject to possible dissolution upon the dissociation of a manager to quite the same extent (albeit very slight) as are limited partnerships and limited liability limited partnerships upon the dissociation of a general partner. Although well-drawn limited (or general) partnership agreements can virtually eliminate this problem, especially if the general partners are themselves limited liability entities and there is at least one remaining general partner, LLCs may still be considered slightly more asset-protective than limited partnerships in this one particular regard.

On the other hand, it would seem to be far more important that every LLC is subject to the risk of its assets being stripped away to purchase for cash the distributional interests of any of its members who dissociate. As the statute provides:

“A limited liability company shall purchase a distributional interest of a member for its fair value determined as of the date of the member's dissociation if the member's dissociation does not result in a dissolution and winding up of the company's business under Section 35-1.”

(805 ILCS 180/35-60(a))

The statute further provides that a limited liability company “is dissolved” and, unless continued by the unanimous consent of all members as well as all dissociated members whose dissociation caused the dissolution, its business “must be wound up,” if, on application by a member or dissociated member, there is a finding and entry of a judicial decree that:

“(A) the economic purpose of the company is likely to be unreasonably frustrated;

“(B) another member has engaged in conduct relating to the company's business that makes it not reasonably practicable to carry on the company's business with that member;

“(C) it is not otherwise reasonably practicable to carry on the company's business in conformity with the articles of organization and operating agreement;

“(D) the company failed to purchase the petitioner's distributional interest as required by Section 35-60; or

“(E) the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent with respect to the petitioner.”

(805 ILCS 180/35-1(4))

Perhaps even more importantly, as will be seen in the following discussion of Charging Orders, the company must likewise be dissolved and its business wound up on application of any transferee of a member's interest, such as any creditor that has foreclosed upon such interest, and a resulting judicial determination that it is “equitable to wind up the company's business.” 805 ILCS 180/35-1(5).

In other words, LLCs are subject to a host of default-rule buyout obligations and even dissolution obligations that limited partnerships and limited liability limited partnerships are not. (Compare the complete absence of buyout obligation and the extremely limited possibility of any nonconsensual dissolution under Section 505 and 801 of the Uniform Limited Partnership Act (1997)). This is a serious potential flaw in the asset protection that they provide.

While this flaw can be partially addressed by specific provisions of an LLC operating agreement modifying these default rules, most standard operating agreements that have been reviewed by this author do not deal sufficiently specifically with all these points. This problem is inherent in the markedly different default rules of the respective statutes: those for limited partnerships and limited liability limited partnerships accomplish an excellent asset-protective result--for example, no distributions to any dissociating partner except upon dissolution--unless changed, whereas those for LLCs lead to an inferior result, at least in regard to buyouts upon dissociation and nonconsensual dissolution.

All of LLCs' profits and management control, like those of general partnerships, must also be shared equally among all members except as otherwise specified by their operating agreement.

These problems, among others, may have originated in the initial model of most LLCs as member-managed--as, so to speak, limited liability partnerships before their time. Certainly, the statutory default rules for member-managed LLCs pose buyout and dissolution problems similar to those of a general partnership or limited liability partnership, whereas those for manager-managed LLCs, on the whole, at present, do not. But whatever the possible original legislative reasons for the radically different default rules, they exist and can create many unintended harmful consequences. As a result, the conclusion seems inescapable that limited partnerships and especially limited liability partnerships have now become even more asset-protective than LLCs in a number of important regards.

Of course, a partnership requires more than one owner, whereas an LLC does not. For asset-protection purposes alone, not to speak of relative tax benefits, a single-member LLC would always be preferable to a sole-shareholder business corporation. Its member/manager is expressly protected by statute from personal liability for company obligations (subject to numerous exceptions set forth in State Law Requirements for Limited Liability section, below) and may be a limited liability entity. The member/manager's departures from the usual corporate formalities are likewise expressly statutorily allowed.²

LLCs currently offer one other unique asset-protection benefit although it is likely that it, too, will soon be extended to other forms of limited liability entities: the ability to insulate particular assets and associated liabilities of the entity from all its others by the use of separate internal "series." Such Series LLCs are next considered.

G. SERIES LLCs

As of August 16, 2005, Series LLCs have been allowed to be established in Illinois. The necessary public notification of the establishment of an Illinois LLC as a Series LLC is contained in the following reprinted language on the special required Series LLC form of Articles of Organization:

"The operating agreement provides for the establishment of one of more series. When the company has filed a Certificate of Designation for each series, which is to have limited liability pursuant to Section 37-40 of the Illinois Limited Liability Company Act, the debts, liabilities, and obligations incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of the Limited Liability Company generally or any other series thereof, and unless otherwise provided in the operating agreement, none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing respect to this company generally or any other series thereof shall be enforceable against the assets of such series."

In turn, Section 37-40 of the statute provides, among other things, that if separately designated series of members, managers, or ownership interests having separate rights, powers, or duties with respect to separate properties or businesses belonging to those series are created

² On the other hand, the sole shareholder of a business corporation may install whichever individual directors and, through them, officers whom that shareholder wants, just as the sole member of a single-member LLC may install whichever manager that member wants; there is no functional difference in a sole owner's power over each of the two respective entities except that the directors and officers of a business corporation must be individuals.

by the operating agreement; if “separate and distinct” records and accounts are kept for each such series and all the assets associated with such series pursuant to the requirements of the operating agreement; and if separate “certificates of designation” are filed for each series that is intended to be treated (in accordance with the above-mentioned public notification) as in effect a separate legal entity, then each series will be treated in that favorable fashion. Thus, any liabilities associated with that series will not spill over to affect any other series or, indeed, the rest of the limited liability company, and vice-versa.

This is a powerful tool for reminding Series LLC owners of this importance of isolating various possibility liability-creating properties or businesses in separate “cells” so as to protect the overall value of all those ownership interests from destruction by liabilities or losses associated with only a few of them. It is at present only available for LLCs, although the statutory extension of its permitted use to other forms of limited liability entities may be anticipated.

With that said, it must also be noted that exactly the same “spillover” liability-limiting effect can be accomplished more surely by setting up entirely separate entities--multiple different LLCs or limited liability limited partnerships, for example. Also, the very existence of those completely separate entities (the ultimate default rule) would tend to force their respective owners and agents to operate them separately, whereas such an approach would instead always have to be carefully adhered to in a Series LLC. In the end, therefore, Series LLCs' special attraction may amount to only a modest saving in total filing fees at the Secretary of State's office.³

The relative significance of saving a few hundred dollars per series in initial filing fees, will, of course, depend on the financial circumstances of the particular Series LLC owners. For some, it might prove very attractive, for example, the owners of large, heavily debt-financed portfolios of small investment real estate properties such as rented single-family homes. Other varieties of small businesses might also benefit from Series LLC status--if all the series' accounts are scrupulously maintained separately as required.

³ Series LLCs do offer the intriguing additional possibility of alternately characterizing some or all of the separate series as separate taxpayers or the same taxpayer for federal income tax purposes, which might produce aggregate income tax savings in certain situations. However, given the inherent practical difficulties of operating a Series LLC with sufficient differences in the ownership and control of the different series to warrant separate-taxpayer treatment in one year but not the next or the one before, this possibility would seem to be largely theoretical.

H. BUSINESS CORPORATIONS

Ordinary business corporations have historically been the principal form of limited liability entities, and their chief legal characteristics--shareholders, directors, officers, and various required approvals of corporate actions by meetings or written consents--are so familiar as not to call for any detailed discussion here. From an asset protection perspective, business corporations (including “close corporations” and S corporations, which are merely business corporations that meet certain additional requirements) remain a highly satisfactory long-proven legal device. Expecting the shareholders periodically to elect directors, the directors to direct, and the corporate officers whom they appoint and direct to act as the agents of the corporation, not as principals, is not, after all, onerous. Also, although directors and officers of corporations must be individuals and do not benefit from the same express statutory protection against personal liability that managers of LLCs and general partners of limited liability partnerships and limited liability limited partnerships do, they have long been protected against personal liability by basic doctrines of the common law.

Through shareholder agreements, closely held business corporations can also be made to operate in much the same manner as LLCs or other limited liability entities. The shareholders may agree, for example, to install and maintain particular individuals as directors, knowing that they will, in turn, appoint certain other persons (or themselves) as the officers and otherwise conduct the business of the company in a desired manner. The shareholders may also agree, for another example, to restrict the ordinary free transferability of their shares or to require their purchase in certain circumstances as in “buy-sell agreements.” They can thus create, if they wish, an almost partner-like relationship with one another, without the corresponding personal liability or fiduciary obligations of a partnership.

Close corporations (see 805 ILCS 5/2A.05 et seq.) are simply business corporations whose shareholders have entered into such agreements and declared that fact on their stock certificates and to the State. Their unique feature is the statutory permission for the shareholders of such corporations to operate them directly, thus dispensing with a board of directors. Needless to say, this hardly commends them from an asset protection standpoint. Most corporations with shareholder agreements do not even bother to declare themselves to be “close corporations” because there is no need; their shareholder agreements are just as enforceable whether they do or not.

S corporations are simply business corporations with a certain limited number of shareholders of certain kinds and with only one class of stock that make an election subsequent to their formation to be treated as S corporations for federal income tax purposes. Typically, they, too, have shareholder agreements designed to maintain that tax status.

Finally, it is simply a myth that corporations must constantly observe every punctilio of proper corporate form in order to protect their shareholders, directors, and officers from personal liability. In this regard, the provision in the Limited Liability Company Act that personal liability may not be imposed on any member or manager solely because of departures from ordinary company formalities is reassuring but also misleading if not correctly understood. Corporate directors and officers must for their own legal protection always make clear that their actions are taken as agents of the corporation, and thus, there is for them some risk in ignoring corporate formalities; but corporate shareholders as such do not take any official corporate action for the corporation. Corporate shareholders are not agents in the first place, have no apparent authority, and assume no management or fiduciary responsibility or risk.

To reiterate, business corporations of all kinds confer a great deal of asset protection upon their owners, just as the state legislature has long intended and the courts have long recognized. The asset-protection similarities between business corporations and the other forms of limited liability entities greatly exceed the differences. Their principal drawback relative to other kinds of limited liability entities, apart from the cumbersome appraisal and buyout rights of dissenting shareholders in connection with various corporate transactions, have nothing to do with asset protection.

The principal reason for the sharply increasing use of LLCs instead of business corporations since they were first authorized in Illinois (in 1994), and especially since the Internal Revenue Service issued its “check-the-box” regulations concerning elective entity tax status (in 1996), is, of course, their federal income tax benefits, not any significant increase in asset protection for their business owners.

I. NOT-FOR-PROFIT CORPORATIONS

Not-for-profit corporations formed under Illinois' General Not For Profit Corporation Act of 1986 (805 ILCS 205/101 et seq.) may carry out substantial business purposes and may thus be in every sense of the word limited liability business entities. Most laypersons erroneously assume that a not-for-profit corporation must serve the public, like a charity qualified for federal income tax exemption under Section 501(c)(3) of the Internal Revenue Code or qualified for tax-

deductible gifts under Section 170(c) of the Code, but this is certainly not the case. For example, stock exchanges and other boards of trade were all for many years established and operated as not-for-profits, serving their members exclusively as the immediate “consumers” of their services or facilities (see, e.g., 805 ILCS 105/103.05(a)(26)). The recent trend among the largest such exchanges has been to convert from their long-time not-for-profit status to for-profit status so that they may issue shares of stock, raise outside capital, and further enrich their members. For another example, “professional, commercial, industrial, or trade association[s]” (see 805 ILCS 105/103.05(a)(19)) all qualify as not-for-profit entities although by definition they serve only their members' business purposes.

Nonetheless, the members of an Illinois not-for-profit corporation, as members, enjoy the most sweeping possible statutory protection from personal liability. Section 107.85 of the statute specifies that:

“The members of a [not-for-profit] corporation shall not be personally liable for any debt or obligation of the corporation.”

In turn, for all directors and officers of not-for-profit corporations that are exempt from income tax exemption under any of the subsections of Section 501(c) of the Internal Revenue Code or else at least "qualified" for such exemption, Section 108.70 of the state statute provides an exemption from even the ordinary duty of care, so long as those directors and officers serve without pay. (That same exemption extends to, among other things, business leagues, real estate boards, and boards of trade (see Section 501(c)(6)). No cause of action may be brought against any such person:

“...for damages resulting from his exercise of judgment or discretion in connection with the duties or responsibilities of such director or officer unless the act or omission involved willful or wanton conduct.”

(805 ILCS 105/108.70(a))

Indeed, in the case of not-for-profits that are exempt or qualified for exemption under Section 501 (c)(3) of the Internal Revenue Code, i.e., charities, no cause of action may be brought against anyone rendering unpaid services to or for such a corporation:

“...for damages resulting from an act or omission in rendering such services, unless the act or omission involved willful or wanton conduct.”

(805 ILCS 105/108.70(c))

These provisions go far beyond the protection of the common law “business judgment rule” for directors and, by extension, officers of a business corporation, against alleged breaches of duty of care to the corporation. They go far beyond the express statutory limitations of the duty of care of LLC fiduciaries vis-à-vis their company and the other members, in “the conduct of a winding up of the company's business,” to “grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.” 805 ILCS 180/15.3(c). They protect, to repeat, any persons rendering unpaid services to such not-for-profits against even their own ordinary personal liability for tortious conduct of theirs affecting third parties. For LLC managers or members or corporate directors, officers, or other agents, there can be no escape from personal liability for their own torts (although they may be indemnified by the LLC or business corporation except in the most egregious instances). However, for persons rendering unpaid services to charities, there can be no personal liability under any circumstances unless their alleged wrongful acts or omissions involved “willful or wanton conduct.” And, the statute defines such conduct very narrowly as:

“...a course of action which shows an actual or deliberate intention to cause harm or which, if not intentional, shows an utter indifference to or conscious disregard for the safety of others or their property.”

(805 ILCS 105/108.70(c))

Not-for-profit corporations can not issue shares or pay dividends (except liquidating dividends: see 805 ILCS 105/106.05), so such corporations are not ordinarily thought of as limited liability entities or even business entities. However, as has been seen, many of them--churches being a conspicuous example--do engage in substantial businesses. For their members, directors, and officers, there is the highest level of personal asset protection known to the law, even though that policy does not extend to the asset protection of those entities themselves from claims of liability.

J. PUBLICLY TRADED PARTNERSHIPS

Publicly traded partnerships are limited partnerships without transferability restrictions upon the limited partners' interests that have so many limited partners that their interests are traded on a securities exchange or “readily tradable on [another] secondary market.” I.R.C.

Section 7704(b).⁴ The general rule of Section 7704 of the Internal Revenue Code is that such publicly traded partnerships are to be taxed as if they were C corporations. However, if 90 percent or more of their income is “qualifying income” including, among other things, interest, dividends, real property rents, gain from the sale or other disposition of real property, or income and gains derived from the exploration, development, mining or marketing of any mineral or natural resource (I.R.C. Section 7704(c)), then such partnerships are permitted to be taxed as partnerships.

Publicly traded partnerships pose no special asset protection issues, but the fact that there are numerous such partnerships, each with thousands of unit holders, listed on the major securities exchanges, serves to confirm how similar most of the different kinds of limited liability entities can be.

K-L. PROFESSIONAL SERVICE AND MEDICAL CORPORATIONS

The availability of the LLC entity for the practice of law has already been considered. LLCs may also now be used for the practice of accountancy, architecture, dentistry, engineering, insurance, land surveying, real estate brokerage, structural engineering, or medicine, subject to the respective corresponding professional restrictions and rules.

In addition to LLCs, professionals may also conduct their practices, subject to the same professional restriction and rules, through Professional Service Corporations (see 805 ILCS 10/1 et seq.), i.e., “PCs,” and, in the case of physicians, Medical Corporations (see 805 ILCS 15/1 et seq.)

The common denominator of all these forms of professional practice is that personal liability for the professionals' own malpractice, or that of any of their “ancillary personnel” under their direct supervision and control, may not be limited although many other possible sorts of personal liability (such as, for example, lease liability) may be.

All these sorts of corporations are taxed as either C corporations or S corporations depending on whether they are eligible to make the S corporation election and do so.

II. DESIGN AND COORDINATION OF OWNERSHIP STRUCTURE

⁴ By the same token, such partnerships must comply with all the same securities law requirements that apply to large publicly held or listed companies. It should be emphasized that the antifraud requirements of the securities laws apply whenever there is a sale of a security to an investor, and virtually all such sales to investors in the closely held limited liability entities here primarily considered must also qualify as private placements under the respective federal and state rules concerning the private placement exemptions from the securities registration requirements of public offerings.

A. USING LIMITED LIABILITY ENTITIES TO OWN INTERESTS IN OTHER BUSINESS ENTITIES

The importance of using limited liability entities as the general partners of general and limited partnership goes without saying. The same liability and dissolution-protection rationale could be extended, to a lesser degree, to all the partners or members of even limited liability partnerships, limited liability limited partnerships, and limited liability companies. For example, the express statutory exemptions of their respective owners and operators from personal liability are all put in terms of their nonliability “solely” on account of their acting as general partners, limited partners, or LLC members of managers (see, e.g., 805 ILCS 215/404(c) re limited liability limited partnerships). As will be seen in Part III, the ownership or operation of any limited liability entity could in many cases lead to personal liability even though the status of the owners or operators such was not itself the “sole” basis of liability.

The shareholders of business corporations enjoy a nominally greater degree of asset protection because the statute provides that they “shall be under no obligation to the corporation or its creditors with respect to such shares” except for the obligation to pay for them (see 805 ILCS 5/6.40)(emphasis supplied). However, the established doctrine of “piercing the corporate veil” in appropriate circumstances shows that this nominal distinction in terms of asset protection is in effect a distinction without a difference.

Also, directors and officers of business corporations must be individuals (see, e.g., Section 8.10(c) of the statute concerning the terms of individual directors and Section 8.50 concerning the officers “whom” those directors shall elect). This is a potentially significant shortcoming in the asset protection of corporations as opposed to other limited liability entities, at least for those who run them.

However, this is also the exception that proves the above-mentioned rule that it is always desirable from an asset protection standpoint, whenever possible, to install limited liability entities as the owners as well as operators of other limited liability entities in order to achieve the maximum asset protection.

In this regard, it should be emphasized that trusts, although they are not ordinarily themselves business entities, are nevertheless entities separate and distinct from their beneficiaries. Thus, they, too, may be used--and very often are used--as part of the overall ownership structure of limited liability entities. (Indeed, some of the largest shareholders in this country are retirements plans organized as trusts.)

Similarly, not-for-profit corporations may become the owners of separate for-profit subsidiaries and may establish networks of affiliated not-for-profits under the same direction and control, again realizing the benefits of a “tiered” ownership structure of multiple limited liability entities, even though not-for-profits may not have shareholders as such.

The larger the overall business organization becomes and the more assets that it has to protect, the greater become the asset protection advantages of multiple tiers--tiers upon tiers--of affiliated limited liability entities. Thus, the organizational charts of most major business enterprises typically resemble a Christmas tree, with an ultimate holding company (not an ornament!) at the top, numerous tiers of divisional and subdivisinal holding companies in the middle, and many scores of operating companies at the bottom. Another new limited liability entity is formed for each new venture that can effectively be carried out by it, for the compelling business purpose of the isolation and resultant protection of all the other assets of the group.

Section 1504(a) of the I.R.C. defines an “affiliated group” as “1 or more chains of includible corporations connected through common stock ownership with a common parent corporation which is includible corporation,” but only if the common parent “owns directly” stock possessing at least 80 percent of the total voting power and stock value of at least 1 of the other includible corporations, and stock meeting those same requirements in “each of the includible corporations (except the common parent) is owned directly by 1 or more of the includible corporations.”

Such “affiliated groups” qualify for “consolidated return” income tax filing for the entire group and complete relief from inter-corporate dividend taxation under Sections 1501, 1504, and 203 of the Internal Revenue Code.

For another example of multiple tiering, publicly traded limited partnerships are ordinarily structured as the “holding partnerships,” so to speak, of operating limited partnerships owned almost entirely by them but managed by yet other limited liability entities.

As seen above, on a much smaller scale, Series LLCs are designed to permit this same sort of tiering or separation of assets and operations within a single limited liability entity. Indeed, each series comprises for asset protection purposes a separate entity unto itself. This is (so far) a unique advantage of Series LLCs in that all other limited liability entities must resort to the establishment of other formally separate limited liability entities in order to achieve the same kind of asset protection.

Single-member LLCs are already widely used as a means of structuring groups of commonly owned limited liability entities into parent-subsidary and “brother-sister” relationships. Indeed, given the complete income tax look-through allowed for these entities, i.e., their complete disregard for federal income tax purposes as if they were sole proprietorships, they may be expected to be used more and more in the future in place of wholly-owned business corporation subsidiaries. For one reason, the look-through of inter-company dividends coming to them is not dependent on their ownership of at least 80 percent of the stock of the companies paying them, as with affiliated groups. For another reason, the absence of any requirement for individual directors and officers, such as applies to business corporations, allows the member of a single-member LLC to have complete control of its operations without imposing potential personal liability on any individual manager.

From an asset-protection standpoint alone, single-member LLCs are somewhat less protective than multi-member LLCs. This conclusion follows from, among other things, the well-known Colorado Bankruptcy Court decision in In re Ashley Albright, 291 B.R. 538 (Bankr. D.Colo. 2003), wherein the Court decided that, even in the absence of circumstances calling for the application of the “alter ego” doctrine, the bankruptcy trustee should be able to take direct control of a single-member LLC owned by the debtor and liquidate all its assets for the benefit of the debtor's creditors. That decision was based on the Court's view that there is no reason to limit a charging order to recovery against a member's distributional interest in an LLC as opposed to the LLC's underlying assets, if there is not another member except the bankruptcy debtor. Thus, it is preferable from an asset-protection standpoint, for an LLC to have at least one other member with more than a nominal “peppercorn” interest. Id.

Nevertheless, the convenience of inserting single-member LLCs into a group of limited liability entities, because of their complete tax transparency, together with the possibility of their having no individual directors or officers, will often override the relatively slight resulting diminution in asset protection.

Finally, since 1996, S corporations have been permitted to own more than 79% of the stock of other corporations. In fact, if they own 100 percent of another domestic corporation that qualifies as an S corporation and if they elect to treat that other corporation as a Qualified Subchapter S Subsidiary, that “QSST,” like a single-member LLC, will be disregarded for federal income tax purposes. Thus, S corporations, too, may now be used to achieve a complete

“look-through” of all the federal income tax attributes of other legally separate entities that they own.

Apart from their now lending themselves to such a tiered structuring of limited liability entities, S corporations have long been used as the general partners of limited partnerships. This is because of their federal income tax status as pass-through entities despite their state corporate law status as limited liability entities. They are also increasingly being used as the managers of LLCs in order to save employment taxes, as discussed in the Income Tax Comparison section, below.

III. STATE LAW REQUIREMENTS FOR LIMITED LIABILITY

The state law requirements for limited liability of the owners and operators of limited liability entities include a variety of specific actions that they must avoid taking as well as a general doctrine of how the entities themselves must be operated so as to avoid a so-called “piercing of the corporate veil.”

In the first category, one of the leading treatises on LLC law lists all of the following as “some of the situations in which a member can be held personally liable”:

- A member guarantees, provides collateral for, or agrees to be personally liable for an LLC debt or obligation.
- The Articles of Organization or the Operating Agreement directs that one or more members are personally liable for LLC debt and liabilities.
- A member who acts as an LLC without the authority to do so can be jointly and severally liable for all debts and liabilities.
- If the LLC is not properly formed, i.e., statutory formalities for organizations are not filed or improperly filed, the “member” is personally liable. It is important to note that this is different from piercing the LLC veil. With piercing the LLC veil, the LLC is validly existing entity that is only disregarded for liability purposes. Comparatively, an improperly formed LLC does not exist; thus there is no veil to be pierced, and is disregarded for all purposes.
- A member who assents to an improper distribution can be held personally liable.
- A member is liable for fraudulent acts committed by the member before the LLC was formed.
- A member is liable for his or her own tortious conduct.

- Members of a professional LLC are liable for their own malpractice.
- A member who is not protected by [the] Workers' Compensation Act can be liable for his or her own wrongful actions.
- A member is liable for his or her own criminal conduct.
- A member is liable for conducting or transacting business under an improper name that is not properly registered.
- If a member knowingly executes a false document (either Articles of Organization, certificate of amendment, or other certificate) and someone suffers loss by reasonably relying upon the document, the one relying can recover damages from the member.
- A member will be personally liable on a debt if the debt does not clearly indicate that it is a debt to be paid by the LLC. If the signatures on the debt do not indicate that the individuals are signing in their representative capacities on behalf of the LLC, then it will be assumed that the individuals signed the debt in their individual capacity. As a result the individuals will be personally liable for the debt. Whether the agreement was entered into in an individual or representative capacity is a question of fact. Thus, it is crucial that a member who is signing a debt or liability on behalf of the LLC clearly indicates on the instrument that he or she is signing in his or her representative capacity.
- A member of an LLC may be liable under section 5 of the Federal Trade Commission Act (FTCA). Under section 5, individuals may be held liable for the acts of a company based upon either an individual having (1) directly participated in the violative actions, (2) played a part in controlling, directing, or formulating the policies and practices of the company which violate section 5, or (3) the authority to control the actions of other individuals combined with the actual or constructive knowledge that those individuals were committing misrepresentations.
- A member may be liable under a state Unfair Trade Practices Act. Several states have adopted the criteria set out in the "cigarette rule" by the federal trade commission for determining when a practice is unfair. The elements are: (1) whether the practice, without necessarily having been previously considered unlawful, offends the public policy as it has been established by statutes, the common law, or other established concept of fairness; (2) whether it is immoral, unethical, oppressive, or unscrupulous; and (3) whether it causes substantial injury to consumers, competitors, or other business persons.
- A member may be liable under a state statute. For example, in Oklahoma, the member and managers who have the duty to collect and remit taxes for the LLC are liable for the tax. If no members or managers are identified as having the duty to collect the taxes, then all members and managers are liable for the tax. In Nebraska, members of an LLC are liable in the same manner as a corporate officer for unpaid taxes imposed upon an LLC when management is reserved to the members. In Georgia, a member may be personally liable for tax liabilities arising from the operation of the LLC. Under the

Pennsylvania Wage Payment and Collection Law, if a member of an LLC is deemed to be an “employer,” then the member may be personally liable for unpaid employee wages. Under Utah law, members are personally liable for unpaid wages of employees of the LLC.

- A member may be liable for any obligation of the LLC, if a corporate shareholder would be liable for that same obligation if it belonged to a corporation.

(Wayne A. Hagendorf, The Complete Guide to Limited Liability Companies (1996-2006), ch. 13, at 13-3 to 13-5)

In addition, Illinois' LLC statute specifically imposes personal liability in favor of the LLC and/or its members upon a member of a member-managed LLC who breaches the statutorily prescribed duties of loyalty, care, good faith, and fair dealing vis-à-vis the LLC and the other members. 805 ILCS 180/15.3. However, in a manager-managed LLC, “a member who is not also a manager owes no duties to the company or the other members solely by reason of being a member.” Id. at subsection (g)(1).

These numerous exceptions to the general rule of limited liability all have their counterparts in partnership law and corporate law. Indeed, the last one listed above--that a member of an LLC may be liable for an LLC's obligation in the same circumstances in which a business corporation's shareholder would be liable for that same obligation if it belonged to the corporation (see In re Chicago Trading Group, Inc., 2001 Bankr.LEXIS (N.D. Ill.))--leads directly to a consideration of the common law doctrine of “piercing the corporate veil” in Illinois.

For a court to pierce the corporate veil and find a shareholder (or other controlling person) liable for the corporation's obligations, two conditions must be met: (1) a complete unity of interest and ownership that causes the separate legal personalities of the corporation and the controlling person to no longer exist; and (2) the presence of circumstances under which adherence to the fiction of a separate corporate existence would work a fraud, promote injustice, or promote inequitable consequences. Jacobson v. Buffalo Rock Shooters Supply, Inc., 275 Ill.App.3d 1084, 215 Ill.Dec. 931, 664 N.E.2d 328, at 331 (N.E.2d) (1996).

As most recently held by the Appellate Court in Fontana v. TLD Builders, Inc., 362 Ill.App.3d 491, 298 Ill.Dec.654, 840 N.E.2d 767 (2005), construing Jacobson:

“In determining whether the 'unity of interest and ownership' proof of the piercing-the-corporate-veil test is met, a court generally will not rest its decision on a single factor, but will examine many

factors, including (1) inadequate capitalization; (2) failure to issue stock; (3) failure to observe corporate formalities; (4) nonpayment of dividends; (5) insolvency of the debtor corporation; (6) nonfunctioning of the officers or directors; (7) absence of corporate records; (8) commingling of funds; (9) diversion of assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors; (10) failure to maintain arm's-length relationship among related entities; and (11) whether in fact, the corporation, is a mere façade for the operation of the dominant stockholders.”

(Fontana, supra, at 503)

There, the Appellate Court cited with approval Fiumetto v. Garrett Enterprises, Inc., 321 Ill.App.3d 946, 255 Ill.Dec. 510, 749 N.E.2d 992 (2001), for the related propositions that “[t]he consideration of whether a corporation is adequately capitalized is based on the policy that shareholders should in good faith put at risk of the business unencumbered capital reasonably adequate for the corporation's prospective liabilities,” and that “[t]o determine whether a corporation is adequately capitalized, one must compare the amount of capital to the amount of business to be conducted and obligations to be fulfilled.” Fontana, supra, at 504.

The Appellate Court also cited with approval another important principle set forth in Fiumetto concerning the significance of the undercapitalization factor: “undercapitalization is less significant in a contract case, where the claim arises from a consensual transaction, than in a tort case, where there is no voluntary dealing.” Fontana, supra, at 505.

However, the Appellate Court held that “the diminished significance of the undercapitalization factor” in that case--a contract case--did not render against the manifest weight of evidence the trial court's ultimate determination that the president of the defendant corporation, though not himself a shareholder or director, was jointly and severally liable for its debts. Id.

In sum, as repeatedly suggested above, the express statutory protection of the members and managers of an LLC from personal liability “solely” on account of their roles as such, like the similar express statutory protections of all partners in limited liability partnerships and limited liability limited partnerships, and the even broader express statutory protection of shareholders in a corporation, both give way whenever a limited liability entity is merely the “alter ego” of its controlling person(s). The special dispensation of the LLC statute for failures of an LLC to observe the “usual company formalities or requirements relating to the exercise of

its company powers or management of its business” (805 ILCS 180/10-10(c)), while of some general significance, pales into insignificance in the presence of undercapitalization and the diversion and/or commingling of company assets whenever a claim, especially a tort claim, and more especially one that results in company insolvency, is made. Indeed, it may serve as a pitfall for the unwary, causing LLC members and managers to think that they need not be concerned about such matters of economic substance because of the relaxation of the “usual” requirements--not all the requirements--of company formalities. If so, such members and managers should think again.

IV. TRANSFERRING ASSETS TO LIMITED LIABILITY ENTITIES FOR ASSET PROTECTION

Mitchell Jones's excellent previous presentation concerning the Uniform Fraudulent Transfers Act has made clear that the transfer of assets to a limited liability entity by an owner or co-owner after the latter has already become subject to a debt is NOT an effective form of asset protection as against the creditor. (In this connection, Hagendorf's treatise also observes about transfers to LLCs by the conversion of other entities into those LLCs after the transferor entities are already subject to a debt or in other circumstances where successor liability is imposed, and that “[a]s a consequence of these rules, fraudulent conveyances are not possible [as to such transfers]. Since a transfer to an LLC will not place assets beyond the reach of creditors and will not change a creditor's rights against the assets, a fraudulent conveyance cannot occur.” Wayne A. Hagendorf, The Complete Guide to Limited Liability Companies, *supra*, at 13-3.)

Hence, the discussion in this section primarily concerns the procedural mechanics of making transfers that are not fraudulent or subject to successor liability in the above sense. However, it should be noted that in most jurisdictions “self-settled trusts,” i.e., trusts, even irrevocable trusts, that are established by a person who is also a beneficiary, remain subject to the claims of creditors of the settlors even if the debts due to those creditors arose long after such trusts were formed and funded and no fraudulent transfer was involved. In those jurisdictions, those creditors are able to reach all assets in such a trust to the maximum extent that the settlors possibly could. Thus, for example, if even an independent trustee had the discretionary power to distribute all the trust income and principal to the settlor, all the trust's assets could be reached regardless of whether the trustee had ever exercised that power to any extent.

In several states, notably including Nevada, Alaska, and Delaware, this common law rule concerning self-settled trusts has been altered by statute so that certain irrevocable discretionary trusts are only subject to the claims of the settlors' subsequently occurring creditors (in the absence of a fraudulent transfer) to the extent that the trust income or principal is actually distributed to those settlors. These are the so-called domestic Asset Protection Trusts, which can lend another measure of security to asset protection plans even for nonresidents of those states.

To return to the main theme, though, the mechanics of asset transfers to limited liability entities are of critical importance. If those transfers are not made, those entities remain mere shells like an unfunded trust. However, the transfers themselves call for careful advance planning and follow-up, especially in the case of real property.

First, the ubiquitous "due-on-sale" clause of real estate mortgages must be considered. Under the federal Garn-St. Germain Act (see 12 U.S.C. § 1701 j-3, "Preemption of Due-on-Sale Prohibitions"), the transfer of one's home to one's own revocable grantor trust is deemed not to be a transfer within the meaning of such clauses, which otherwise typically prohibit any transfers of any interest, even an equitable interest, in the mortgaged property without the advance written consent of the lender. Transfers to limited liability entities are not covered by this statutory exemption and so must receive the required prior approval or become an event of default under the mortgage. Although such a transfer does not release the mortgagor from any preceding personal liability on the note or mortgage, of course, and could only tend to make the loan more secure (by ensuring the asset protection of the borrower's other assets and income from non-mortgage liabilities arising from the ownership of the mortgaged property), many lenders will refuse or at least balk at the necessary approval.

Thus, an adviser of a transferor of real estate or any other encumbered property to a limited liability entity must carefully consider with his or her client the risk of triggering a potential automatic loan default.

Second, after the transfer, it is essential for the transferor to treat the property as actually having been transferred--to notify tenants of the change of ownership, for example, and to collect no further rents from the property in the transferor's own name. Any other practice could constitute the commingling of assets, which, as has been seen, would jeopardize the asset protection of the transferee limited liability entity itself. The danger of such commingling is accentuated in connection with transfers to the transferor's own limited liability entities, where all or most of the ownership interest remains in them. It is so easy for transferors in that context

to neglect to account completely separately for their own entities' new ownership, as they must, from the date of those transfers onward. Series LLCs are, by definition, required to keep the most rigorously separate accounts of the business and property in each respective series; thus, the danger of commingling is at its greatest as to them. But this danger is a general and continuing one and must be constantly avoided.

Third, there is the question of insurance, especially title, casualty, and liability insurance, with respect to the transferred asset. Transferors to their own or their own family's limited liability entities can easily forget to amend the insured parties under the applicable insurance policies, with potentially disastrous consequences.

Fourth, although this might seem overly obvious, the transferors must henceforth at all times act with respect to the transferred property (if at all) strictly as the authorized and so-identified agents of the transferee entities. If they continue to manage the property, for example, they must make clear to all concerned that they are doing so only in their newly assumed capacity as agents. Transfers to limited liability entities can not relieve the transferors from personal liability for their own torts concerning the transferred property, but every attempt must be made to limit the subsequent risks inherent in the ownership itself (for example, premises liability) to the transferee entities. That can only be done if the transferors henceforth make clear to all concerned that they have no further management responsibilities for the property except as the disclosed agents of the respective disclosed new owners.

There are also income tax ramifications of asset transfers to limited liability entities, of course, including the immediate recognition of capital gain if the transfers are made to business corporations (including S corporations) over which the transferors do not have, directly or through the control group to which they belong, at least 80 percent control. These tax aspects will be briefly considered in the "Income Tax Comparison" section of this discussion, below.

V. THE CHARGING ORDER: DOES IT WORK?

The simple answer to the question posed by the title of this section is, Yes. Charging orders do "work" in Illinois. It is a misconception that charging orders merely permit a judgment creditor of a partner, limited partner, or LLC member to receive distributions from the limited liability entity when and as the controlling persons decide to make them to the debtor. It is also a misconception that, while the creditors are being forced to await such distributions, if ever, to satisfy their judgments, they are also forced to include the phantom income from

retained partnership or LLC income, at least unless all the partners or members are also forced to wait for their distributions and to report their own phantom income. Any skewing of tax attributes to the particular detriment of a judgment creditor with a charging order would violate the economic substantiality requirement of Section 704 of the Internal Revenue Code for all allocations of income and deductions.

Indeed, LLCs may be particularly vulnerable if regular distributions are delayed or withheld on account of a charging order. This is because, as previously noted, one of the “events” causing the dissolution and winding up of an LLC's business is a “judicial determination,” on the application of any transferee of a member's interest, that it is “equitable” to wind up the company's business. See 805 ILCS 180/35-1(5). A creditor of any LLC member's distributional interest can become a transferee of that interest by the simple expedient of foreclosing the creditor's lien that is automatically provided by the statute as part of the charging order. 805 ILCS 180/30-20. (This is not the case in certain other states such as Nevada: there, apparently, the charging order does not constitute a lien and does not give rise to a right of foreclosure but is nevertheless declared by the statute to comprise the creditor's exclusive remedy. See, e.g., NRS 86.401 (re LLCs) and NRS 88.535 (re limited partnerships)).

Illinois' Uniform Limited Partnership Act, on the other hand, while it sets up exactly the same lien foreclosure relief as part of a charging order (see 805 ILCS 215/703), does not require any distribution to any partner on account of dissociation. 805 ILCS 215/505. It also does not require any such partnership's dissolution except in the few narrow circumstances defined in Section 801 and 802, none of which include “inequitable” treatment of a partner's creditor.

In this regard, just as in regard to other previously noted differences in the statutory default rules concerning the buyout rights and other rights of member and dissociated members, Illinois LLCs provide somewhat lesser asset protection than do Illinois limited partnerships and Illinois limited liability limited partnerships. If the judgment creditor of an Illinois LLC is not treated “equitably” after obtaining a charging order, that creditor can, by express statutory authority, compel the dissolution of the entity itself.

It remains merely to add that the judgment creditors of corporate shareholders do not obtain charging orders; instead, they execute their judgments directly upon the debtors' stock, by attachment and sale. Like the creditors of limited partners, however, they have no right to any distributions except to the same theoretical extent as do all the other shareholders. Any initial investment by the debtor shareholder in the corporate entity thus remains locked in; there are no

buyout or distribution-upon-dissociation rights. All that they obtain after execution is the shares of stock that the debtor owned--or what an outside buyer might conceivably pay for them--subject to any “applicable restriction” under a shareholders' agreement. (Such “applicable restrictions” would tend to further depress the value of the acquired stock, especially if that stock represented a minority interest without the power to control the corporation or compel its liquidation. However, as will be seen, that additional reduction in value might nevertheless not be taken into account for transfer tax purposes.)

Stock with the necessary voting power to force liquidation, by itself or as the key “swing block” of stock when combined with another, would always be worth at least its liquidation value. By contrast, an illiquid powerless equity interest would always be worth far less. This is the subject of the next section of this discussion.

VI. TRANSFER TAX VALUATION DISCOUNTS AND OTHER TRANSFER TAX CONSIDERATIONS

Certain recent decisions of the Tax Court (see, e.g., Thompson Est. v. Comr., T.C. Memo., 2002-246, aff'd sub nom., Turner v. Comr., 382 F.2d 367 (3rd Cir. 2004); Srangi Est. v. Comr., 115 T.C. 478 2000, aff'd in part, rev'd and rem'd in part, 293 F.3d 279 (5th Cir. 2002); and, again, Strangi Est. v. Comr., T.C. Memo 2003-145, aff'd, 417 F.3d 468 (5th Cir. 2005)), have created a brouhaha among estate planners as to whether transfers to family limited liability entities can “work” any longer so as to permit valuation discounts of the entity ownership interests resulting from those contributions. The short answer to this question, like the question whether charging orders still “work,” is an unequivocal Yes.

The decisions that gave rise to this brouhaha concerned last-minute transfers to limited liability entities that lacked any credible business purpose and that could only be explained by an implied agreement--found by the courts in each case--that the transferors were actually to retain the continued use and benefit of the transferred assets until their deaths. Therefore, under Section 2036(a) of the Internal Revenue Code, all these courts found that the transferors had retained a continued interest in the transferred property until their deaths, resulting in the inclusion of that property in their taxable estates.

This same analysis was initially applied by the United States District Court in Kimbell v. U.S., 244 F.Supp2d 700 (N.D. Tex. 2003), vacated and rem'd, 371 F.3d 257 (5th Cir. 2004). However, on appeal, the Fifth Circuit ruled that the limited partnership and LLC property there

concerned was NOT includible in the transferor's estate because of the exception contained in Section 2036(a) itself for transfers that constitute “bona fide sale[s] for an adequate and full consideration in money and money's worth” applied. The Fifth Circuit ruled that the property transfers to those entities were “bona fide sales” in this sense notwithstanding the concededly lesser market value of the transferor's ownership interest in the transferee entities immediately after the transfers than of her interests in that same property immediately before. Because the transferor had derived substantial consideration beyond the fair market value of the limited liability entity ownership interests received by her upon her transfers, including, importantly, the resulting avoidance of any further personal liability with respect to the transferred assets, the above-stated statutory exception to the general rule of Section 2036(a) applied.

As concluded by the excellent discussion of this line of cases by the leading commentator, Louis Mezzulo, in BNA's Tax Management Portfolio 812-2d: Family Limited Partnerships and Limited Liability Companies:

“The proper focus of a determination of whether there was full and adequate consideration, the [Kimbell] court said, is: (1) whether the partnership interests were proportionate to the value of the property contributed to the partnership; (2) whether the contributed assets were properly credited to the capital account of the contributing partner; and (3) whether on termination of the partnership the partners were entitled to distributions equal to their relative capital accounts. In this case, the Fifth Circuit concluded that there was full and adequate considerations, as each of these requirements had been satisfied.”

(Id. at fn. 145 and related text)

The foregoing remarks are not to be understood as minimizing the importance of good-faith business purposes for the formation of family limited liability entities to which assets are transferred. See, e.g., the same BNA Portfolio's discussion (at footnote 152 and related text) of the recent Tax Court decision in Bigelow Est. v. Comr., T.C. Memo. 2005-65, which distinguished Kimbell on that basis. However, of course, valuation discounts for ownership interests in limited liability entities, as opposed to the market value of the assets transferred to those entities, can still “work.” No gift occurs upon the formation of those entities and the contribution of those assets in return for the proportionate ownership interests in the entities (see Kimbell, supra). Thereafter, provided that there were good-faith nontax business reasons for those transfers in the first place, and that the transferred assets were genuinely meant for the entities' use (not the transferors' continued personal use), the value of subsequent gifts of those

ownership interests in the entities should of course be discounted from their theoretical value upon the liquidation of those entities. Discounts of as much as 50 percent or more may be appropriate, in the expert opinions of business appraisers, to reflect the gifted interests' lack of liquidity and control. Such discounts are justified for the simple reason that those discounted values are all that the gifted interests are worth. See generally L. Mezzulo, BNA Tax Management Portfolio 812/2d: Family Limited Partnerships and Limited Liability Companies, supra, at footnotes 87–102 and related text.

On the other hand, if the owners of interests in certain family limited liability entities have the right to a buyout of their interests upon dissociation, and if that buyout price is based upon full liquidation value, then there is no reason for valuation discounts of those interests. Moreover, if that right is the default rule under the statute, any limitation of that right by means of the limited partnership agreement or operating agreement may be disregarded as an “applicable restriction” under I.R.C. Section 2704(b)(2).

This is why Illinois' Limited Liability Company Act was recently amended to deny the members of a manager-managed LLC the power to dissociate from the company before the dissolution and winding up of the company unless the company's operating agreement specifies the time “or the events upon the happening of which” the member(s) may dissociate. 805 ILCS 180/35-50. If such power existed, any limitations upon the LLC's default-rule obligation to purchase the distributional interest of any dissociated member would be disregarded for federal tax purposes. (The members of member-managed LLCs always have the power to dissociate, by contrast, and thus require a buyout pursuant to the default rule of the statute.) All of this is in marked contrast to the default rule for limited partnerships, which is, to repeat, that “[a] person does not have a right to receive [any] distribution upon dissolution.” 805 ILCS 215/505.

Arguably, the ability of any LLC member under the statute's default rules to obtain a buyout at their involuntary dissociation by death, disability, or bankruptcy as opposed to their voluntary dissociation by exercise of their will (i.e., “power”) to dissociate, could and should, by itself, reduce the amount of the valuation discount for such member's interests in the entity. By comparison, to repeat again, the default rule for limited partnerships is that no person has any right to receive any distribution upon dissociation, whatever the reason. Thus, for purposes of transfer tax valuation discounts as well as for purposes of asset protection, limited partners may properly be regarded as more fully locked into their partnerships than are members of LLCs into their companies, and gifts to them should accordingly receive greater valuation discounts.

For this reason alone, not to speak of the troubling right of a foreclosing creditor of any LLC member to seek dissolution and winding up of the LLC if the creditor is not treated “equitably” (see 805 ILCS 180/35-1(5)), most expert practitioners continue to favor the use of limited partnerships and limited liability limited partnerships over that of LLCs for the maximum safe valuation discounts.

Beneficial interests in trusts are not subject to this particular sort of valuation discounts. However, through the use of Grantor Retained Annuity Trusts (as one particularly effective transfer tax saving device), the valuation of the gifts that are in effect deferred until the end of the annuity period, can be nearly zeroed out. See generally M. Whitney, “Heresy or Prophecy: The Case for Limited Estate Tax Inclusion of GRATs to the Annuity Payment Right,” in the Real Property, Probate and Trust Journal (ABA 2006), Vol. 41, No. 2, at pp. 381 *et seq.* Theoretically, it should be possible to leverage GRATs consisting of interests in limited liability entities by valuation discounts of those interests themselves, thus achieving the maximum possible transfer tax savings. However, the above-mentioned BNA Tax Management Portfolio cautioned (at footnote 182 and related text) that a taxpayer representation in at least one private letter ruling approving the terms of a GRAT, that no valuation discount was taken in connection with the transfer of a limited liability interest to the GRAT, “may indicate that the Service has adopted the position that the transfer tax leveraging allowed through the use of a GRAT may not be combined with lack of control and lack of marketability discounts.”

VII. INCOME TAX COMPARISON

As observed above, limited liability companies provide somewhat less asset protection to their owners than do limited partnerships and limited liability partnerships. They likewise provide less protection to their owners than do business corporations (though not the individual directors and officers of the latter). But the overall practical differences in the relative amounts of asset protection provided by these entities are slight. Thus, to repeat, the primary reason for the rapid growth in the use of LLCs since 1994 and especially since 1996 (when the I.R.S. issued its “check-the-box” regulations: see Reg. § 301.7701.3), has unquestionably been their federal income tax benefits.

Apart from single-member LLCs, which are in almost all cases entirely disregarded for income tax purposes, leading to their frequent use as part of an overall organization of related limited liability entities, almost all LLCs elect to be taxed as partnerships under Subchapter K of

the Internal Revenue Code. Thus, they have, in common with all other partnerships, the tax benefits of being a pass-through entity. Only the partners themselves are taxed and only on their respective allocated shares of the partnership's income, deductions, and other tax attributes. I.R.C. §§ 701, 702. Those shares, too, may be specially allocated to the tax advantage of particular partners so long as those allocations possess economic substance. I.R.C. § 704.

Partners' contributions of appreciated property to the partnership are, except in rare instances, tax-free regardless of whether those partners are part of a control group owning 80 percent or more of the equity. I.R.C. § 721.

Partners' tax bases may include their respective shares of partnership liabilities, thus creating the possibility of substantial passed-through deductions for the partners, subject to the “at risk” and “passive loss” limitations.

Partnership distributions, of all kinds, even in liquidation, are also in general tax-free. I.R.C. § 731.

All of these favorable income tax features of partnerships are in contrast to the corresponding unfavorable income tax features of C corporations, i.e., corporations taxed according to Subchapter C of the Code, which are so well known as not to require discussion here.

True, C corporations and S corporations may engage in tax-free reorganizations under Section 368 of the Code, whereas partnerships may not. This is one of the few relative benefits of corporate as opposed to partnership income taxation. However, because of the very liberal rules regarding tax-free distributions by partnerships, this factor is not usually of any significance. (Partnerships may carry out nontaxable partnership-to-partnership conversions, anyway, pursuant to Section 721). Even where it might be of some significance an LLC has the right to elect corporate status for income tax purposes under the aforementioned check-the-box regulations.

The only form of ordinary business corporations that provides income tax benefits at all comparable to those of LLCs and partnerships is the S corporation. Assuming that it has not been converted from a C corporation with earnings and profits or “built-in gains,” an S corporation provides essentially the same tax-free pass-through of income and deductions as a partnership. However, an S corporation shareholder's basis is not increased by that shareholder's proportionate share of any company liabilities unless the shareholder is personally at risk as to them. An S corporation may not make the Section 754 election that a partnership may to

increase a newly incoming purchasing shareholder's allocated portion of the entity's own internal basis in its assets to reflect the purchase price of that stock and thus minimize the shareholder's allocated gain upon the sale of those same assets. Worse still, upon liquidation, an S corporation is itself subject to capital gains tax--and thus not treated as a complete pass-through entity--although the former shareholders are allowed to increase their bases in any distributed appreciated assets by their proportionate share of that tax.

S corporations may not have more than 100 shareholders (although family members are now treated as a single shareholder) who must all (except in the case of Qualified Subchapter S Subsidiaries as previously discussed) be individuals who are not nonresident aliens; estates; certain kinds of trusts; or “qualified tax-exempt shareholders.”

The shares of an S corporation must consist of only one class of stock, although some differences, such as voting rights, within that single class are permitted so long as they do not amount to economic preferences.

These rigidities of the equity capitalization of S corporations obviously compare unfavorably to the complete flexibility available to LLCs (especially Series LLCs), partnerships, and C corporations.

However, as previously mentioned, S corporations do provide one important tax benefit that partnerships do not--in regard to employment taxes. The deemed dividends of an S corporation, i.e., all of its passed-through net income, are not treated as earned income for purposes of employment taxes, whereas all the income of partners except for limited partners ordinarily is so treated. (Limited partners are only required to report any “guaranteed payments” that they receive from their partnerships in return for their services, if any, as employment income.) This factor can by itself make S corporations more desirable than partnerships from an overall combined tax standpoint in a variety of situations. One such situation has long been their use as the general partners(s) of limited partnerships. Another is their increasingly common use as the managers of manager-managed LLCs, the non-managing members of which may thus become comparable to limited partners and escape any employment taxes on their passed-through income other than guaranteed payments for services performed (although this favorable result is not so nearly certain in the case of LLCs as it is in the case of limited partnerships, where it is required by statute: see I.R.C. Section 1402 (a)(13)).

Illinois' income tax treatment of limited liability entities generally follows their federal income tax treatment except for the applicable rates.

Illinois' personal property replacement tax, it should be mentioned, is 2 1/2 percent upon C corporations and 1 1/2 percent upon LLCs, partnerships, and S corporations except that single-members LLCs are disregarded for purposes of that additional tax.

VIII. WHEN LLPS OR LLCs ARE NOT USEFUL

Except for those Publicly Traded Limited Partnerships which receive “qualifying income” as discussed above and are thus permitted to be taxed as partnerships, all other limited liability entities are taxed as C corporations as soon as their ownership base expands to the point where their equity interests are or could be publicly traded. Therefore, with the very important exception just noted, the limited partnership and limited liability company vehicles hold few attractions to such large numbers of investors. In that sense, subject to that exception, they could be regarded as relatively unuseful at that level of business operations.

On the other hand, they do offer greater asset protection for their general partners and managers than is allowed for individual officers and directors of corporations, and are thus always potentially useful for them.

Other circumstances in which limited partnerships or limited liability companies in particular might seem to be of little use are those described in the foregoing discussion of the State Law Requirements For Personal Liability. For example, the existence of an LLC will not shelter an LLC manager from personal liability for that manager's own torts whether or not they are also the torts of the LLC. However, in general, the very existence and use of the limited liability entity structure tend to minimize the practical risk of personal liability. “Piercing the corporate veil” is always difficult because the overall policy of all the limited liability statutes is to encourage the undertaking of business ventures by permitting the curtailment of individual personal asset risk.

Moreover, although there can not be single-partner partnerships, single-member LLCs, especially Series LLCs, confer major asset protection benefits upon their respective owners along with a complete look-through of tax attributes. That is surely “useful.”

Ultimately, it would seem, there is no reason for any ongoing regular business not to be conducted in some limited-liability form unless there is so little potential liability associated with that business, or so little apart from unavoidable potential professional malpractice liability or other unavoidable personal liability (such as personal guaranties) that creditors will demand in any case, that the costs of establishing and operating the entity exceed the benefits. Given the

modest costs ordinarily involved, most sole proprietorships, and especially general partnerships, would probably benefit by conversion to a limited liability form.

IX. ESTATE TAX PLANNING CONSIDERATIONS

Several of the most important estate tax planning considerations concerning limited liability entities have already been discussed under the heading of "Transfer Tax Valuation Discounts and Other Transfer Tax Considerations." To reiterate the most important points, substantial transfer tax valuation discounts can definitely be achieved by a program of lifetime gifting of unmarketable, noncontrolling interests in family limited liability entities, and if those entities are actually conducted as a business would be for substantial business purposes the I.R.S. should be unsuccessful in any attempts to draw such gifts back into the donors' estates after their deaths under I.R.C. § 2036 or § 2038.

Moreover, if the gifting program has reached the point where the donor only retains an unmarketable, noncontrolling interest in the entity at the time of the donor's death, even that interest may appropriately be discounted for estate tax purposes.

All this is in contrast to the situation in which the gifts of interests in the limited liability entity are deferred until the owner's death. In that case, no discounts are available. If the entire taxable estate is less than the exemption equivalent amount (\$2 MM this year and next, less any prior taxable gifts), this may be a desirable outcome because of the step-up in the tax basis of estate assets other than "income in respect of a decedent" to their market value as of the date of the decedent's death under I.R.C. § 1014. However, for larger estates, the failure of the owners to take advantage of readily available valuation discounts by lifetime gifts of interests in limited liability entities, perhaps further leveraged by the use of GRATs (as suggested above), would be difficult to justify.

Indeed, even the expensive procedural necessity of obtaining qualified professional appraisals to support claimed valuation discounts of taxable gifts, can be of distinct benefit to donors. The filing of the corresponding gift tax return, supported by such an appraisal, starts the statute of limitations running against I.R.S. attacks on the claimed gift. Even if in theory the I.R.S. could still argue many years later, upon the donor's death, that the duly reported gifted asset remained sufficiently in the donor's "possession or use" (in an extreme case) to warrant reinclusion in the donor's estate under I.R.C. § 2036, this risk could only be reduced by the

timely filing of properly documented gift tax returns as the gifts were made. It is important to note in this connection that none of the recent cases in which the courts have found an implied agreement that the donors would have the continued use of the gifted assets -- thus causing the inclusion of those assets in their estates under § 2036 -- involved such long-standing previously reported taxable gifts.

Lifetime gifts through the use of limited liability entities allow for relatively safe valuation discounts, then, that are not generally available for direct ownership interests in the underlying assets or beneficial interests in trusts that own the underlying assets.

In addition, the donors may, relatively safely (under §§2036 and 2038), retain much greater control over a limited liability entity that they use as the vehicle for their gifts than they may over a trust. Although it is safest, of course, for the donors eventually to relinquish control, the fact that they may have it at all, even while making their gifts, makes limited liability entities an attractive "trust substitute" for many donors in many situations.

On the other hand, the common use of family limited liability entities to make discounted gifts that are NOT reported to the I.R.S. on the theory that their discounted value is less than the annual exclusion amount (\$12,000.00 per year per donee: \$24,000.00 with spousal gift-splitting), is fraught with peril. Under Hackl, some of the very same factors that would qualify the gifts for valuation discounts could disqualify them as "present interests" eligible for the annual exclusion. And, with no gift tax return and supporting appraisal filed, the statute of limitations against the I.R.S. attack would never start running.

Thus, in regard to their transfer tax benefits just as in regard to their asset protection benefits, limited liability entities are best used carefully, with full knowledge of the safest ways to realize all their benefits. In a word, they call for careful planning, ideally with expert professional advice.