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# CORPORATION, SECURITIES & BUSINESS LAW FORUM

*The newsletter of the ISBA's Section on Corporation, Securities & Business Law*

## The misunderstood limited liability partnership: A comparison to limited liability companies

By Kenneth J. Ashman and Bardia Fard\*

Most practicing attorneys have at some point been presented with the following question: "I want to start a new business, what entity form should I select?" A typical answer to this question involves discussion of sole-proprietorships, general partnerships, limited partnerships, "C" and "S" corporations, and limited liability companies ("LLCs"). A well-reasoned answer, however, should also include discussion of the elusive limited liability partnership ("LLP"), an entity form with which many practitioners are not very familiar. Indeed, take an informal poll among your colleagues, and you will likely come to the realization that many practitioners have difficulty articulating

the differences between LLPs and LLCs. This probably explains why there are approximately 119 times the number of domestic and foreign LLCs registered in Illinois over LLPs: 219,870 to 1,847.<sup>2</sup> Yet, in some circumstances, an LLP is probably better suited and more cost effective for your clients. This article provides a primer on certain similar and dissimilar features of LLPs and LLCs as organized under Illinois statute.<sup>3</sup>

### The History Behind LLPs and LLCs

The nation's first LLP legislation was proposed by Texas lawyers in 1991 in an effort to shield professionals, like lawyers and accountants, from being held vicariously liable for the misdeeds of their partners. By 1997, the year the LLP was sanctioned under the Uniform Partnership Act, over 40 states recognized the LLP form. Like other states, the Illinois LLP is nothing more than a general partnership that has filed a form with the Secretary of State to obtain certain liability protections. Accordingly, Illinois LLPs are created and governed, like general partnerships, under the Illinois Revised Uniform Partnership Act ("RUPA").<sup>4</sup>

Limited Liability Companies, on the other hand, significantly pre-date LLPs, as they were first introduced in 1977 by the Wyoming legislature. However, the adop-

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tion of LLC statutes among the remaining states was delayed by uncertainty as to how the IRS would classify LLCs for income tax purposes. States' reservations were quelled in 1988 when the IRS ruled publicly that LLCs could be treated as partnerships if they satisfied certain then-existing classification rules.<sup>5</sup> Since then, all states have adopted legislation authorizing LLCs. In Illinois, LLCs are created and governed under the Illinois Limited Liability Company of 1994 ("LLC Act"), which was significantly revised in 1998.<sup>6</sup>

### Differences in Basic Characteristics?

Initially, there are differences in the terminology of LLPs and LLCs worth noting. Whereas an LLP is formed by filing a Statement of Qualification with the Secretary of State, an LLC is formed by filing Articles of Organization.<sup>7</sup> Further, co-venturers in an LLP are called "partners," while co-venturers in an LLC are called "members." The relationship between partners and the LLP are governed by a Partnership Agreement, and the relationship between members and the LLC are governed by an Operating Agreement. In the event that an LLP fails to provide a written Partnership Agreement, or an LLC failed to provide a written Operating Agreement, the default provisions of

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each governing statute, whether RUPA for LLPs or the LLC Act for LLCs, will govern.<sup>8</sup>

The management structure of an LLC can be either member-managed or manager-managed.<sup>9</sup> By statute, in a member-managed structure, managerial control and binding authority are vested in all of the members, although the particular roles of various members may be spelled out and/or modified from the statute in the Operating Agreement.<sup>10</sup> In a manager-managed structure, one or more individuals (members or otherwise) are authorized to manage and bind the LLC.<sup>11</sup> In an LLP, each partner automatically has the apparent authority to bind the partnership,<sup>12</sup> unless the LLP files a "Statement of Partnership Authority" which provides limitations on authority of some or all of the partners.<sup>13</sup> In effect, the "Statement of Partnership Authority" is similar to structuring an LLC as manager-managed.

Both LLPs and LLCs are entitled to pass through tax treatment (although an LLC may be taxed as a corporation if it so chooses), may continue even after a partner/member death, and may allow for different classes of ownership. LLPs, however, require a minimum of two partners, whereas a single-member LLC is expressly authorized by statute.<sup>14</sup> Depending on the number of partners, the initial start-up and annual fees for an LLP can be significantly more than for an LLC, as Illinois requires the payment of \$100 for each partner, up to a limit of \$5,000 – every year.<sup>15</sup> By contrast, the initial start-up fee for an LLC is \$500 (for the filing of the Articles of Organization), with a \$250 annual fee, irrespective of the number of members.<sup>16</sup> Thus, if the LLP has only two partners, it is less expensive than an LLC both to start-up initially and maintain annually; if the LLP has three or four partners it is less expensive than an LLC to start-up initially, but would pay slightly more per year; and if the LLP has five or more partners, it will prove more expensive overall than maintaining an LLC.

Finally, Illinois is one of only a handful of states that permits the organization of an LLC commonly known as a "Series LLC," that has the ability to create within itself separate "series" that have their own interests, members, and liabilities.<sup>17</sup> This type of LLC is frequently used in real estate investment transactions, where an investor owns a number of rental buildings, but does not want the assets of one building to be at risk for the liabilities of another building. From an asset protection perspective, each series in the

Series LLC can own distinct assets, incur separate liabilities, and have different managers and members.<sup>18</sup> Thus, under Illinois law, the assets of one series are not subject to the liabilities of any other series. That said, the issue of whether a federal bankruptcy court would follow state law on the segregated liability of each series in a Series LLC is an open one, as the authors' research has uncovered no decisions addressing the question, so practitioners should be aware of this potential risk.<sup>19</sup> From a cost perspective, a Series LLC is beneficial in that multiple filing fees and tax returns are avoided, as the Series LLC may be viewed as a singular entity. The initial start-up fee for a Series LLC is \$750 plus \$50 for each series created thereunder, with the annual fee pegged at \$250 plus \$50 for each designated series.<sup>20</sup>

### Difference in Liability Protection?

A question arises as to whether there exists differences in the liability protection afforded by LLCs and LLPs. In some states, including Illinois prior to 2003, partners in an LLP are only protected from liability arising from the negligence, wrongful acts, or misconduct of other partners in the partnership, *e.g.*, tort claims. Put differently, partners of LLPs formed under these states' statutes can still be held personally liable for the contract obligations of the partnership. State statutes that confer this limited form of liability protection are called "partial shield" statutes.

In 2003, Illinois adopted RUPA, which provides that a partner in an LLP is not liable for any of the liabilities incurred by the partnership, whether the liability originated in tort or contract.<sup>21</sup> This type of statute is often referred to as a "full shield" statute. With the implementation of a full shield statute in Illinois, the liability protections provided to partners in an LLP are now identical to those provided to members in an LLC.<sup>22</sup> It worth noting, however, that despite the liability protections provided under each statute, attorneys at firms organized as LLPs or LLCs are not relieved of liability for malpractice claims.<sup>23</sup>

### Differences in Capital Structure?

Some practitioners wonder whether the requirements for capital structure differ in LLPs from LLCs, such as exists between the capital structures of "S" corporations and "C" corporations ("S" corporations restrict the number and types of shareholders, and the classes of shares, for example). In Illinois, there

are no differences between the potential capital structures of LLPs and LLCs. Both LLPs and LLCs afford considerable flexibility, in that they may have unlimited partners or members, unlimited classes of ownership, and may permit any type of entity to become a partner or member. Moreover, profits and losses may be allocated in any way the equity holders so choose; however, in the event that the equity holders do not specify in the Partnership Agreement or Operating Agreement how such profits and losses will be allocated, each governing statute (RUPA and the LLC Act) provide a default provision that such profits and losses will be allocated equally among the partners/members.<sup>24</sup>

### Differences in Fiduciary Duties Owed?

Are there differences in the fiduciary duties owed by the partners or members to their respective co-venturers and business entity? The answer is, "yes," depending on whether the LLP is compared to a *member-managed* or *manager-managed* LLC.

As between an LLP and a member-managed LLC, there exists no difference between the fiduciary duties owed by partners or members.<sup>25</sup> Individual partners and members owe their respective partners/members and partnerships/companies the duties of loyalty, due care, and good faith and fair dealing.<sup>26</sup> Further, the governing document for each entity, be it a Partnership Agreement or Operating Agreement, may not generally eliminate fiduciary duties, but may (i) identify categories of activities that do not violate these duties, provided it is not manifestly unreasonable; (ii) specify the required number or percentage vote needed to authorize an act or transaction that would otherwise violate the duties owed; or (iii) specify the standard by which the obligation of good faith and fair dealing is to be measured.<sup>27</sup>

With respect to manager-managed LLCs, however, a member who is not a manager owes no fiduciary duties to other members or to the company solely by virtue of being a member.<sup>28</sup> Instead, all of the fiduciary duties otherwise owed to members and the LLC in a member-managed LLC are now reposed in the manager.<sup>29</sup> That said, members who, under the Operating Agreement, exercise some or all of the authority of a manager are subject to the full spectrum of fiduciary duties that any manager owes.<sup>30</sup> There is no corresponding provision governing LLPs that eliminates, whole-

sale, the fiduciary duties that any partner would have to another or to the partnership, even if a Statement of Partnership Authority is filed with the Secretary of State designating certain partners with greater authority than others. Moreover, as noted above, a Partnership Agreement may not be modified to eliminate all fiduciary duties. Thus, as between a manager-managed LLC and an LLP, the fiduciary duties of a non-managing member are less than those of any partner.

### Differences in Distributions?

Where an LLC or LLP has funds available to it, the entity may – but is not required to – make a distribution of such funds, or a portion thereof, to its members or partners. Since both LLCs and LLPs are treated as partnerships for tax purposes, both members and partners are liable for income taxes to the extent of their proportional share of income earned by the entity.<sup>31</sup> Simply because the income of the entity has been proportionally allocated to the member or partner, however, does not mean that the member or partner is entitled to a corresponding distribution of such income, leaving the member or partner with a potentially unfunded tax liability. In *Five Star Concrete, LLC v. Kling*, an Indiana case interpreting a limited liability statute that parallels Illinois law, the court explained: “Nowhere does the Act provide that allocation of income to members for income tax purposes creates an automatic legal right to receive a distribution in the amount of that income, even when a member is withdrawing from the LLC. Indeed, there are times that such a distribution would be unlawful,” such as where it would leave the LLC insolvent.<sup>32</sup>

Thus, with respect to an entitlement of distribution, the statutory provisions governing LLCs and LLPs are identical. One difference does lie, however, where an “unlawful” distribution is made in the LLC context. Unlawful distributions are generally defined as distributions rendering the LLC insolvent or, at least, without sufficient cash to pay its debts.<sup>33</sup> A member or manager may be held personally liable for (i) receiving an unlawful distribution, (ii) voting for an unlawful distribution, or (iii) in some instances, knowing that an unlawful distribution was made.<sup>34</sup> Under RUPA, no parallel provision exists, but a partner who receives or approves of a distribution leaving the LLP insolvent may face personal liability under common law principles or, perhaps, under a fraudulent conveyance statute – the

exact contours of which are beyond the scope of this article.

### Differences in the Transferable Interests and the Rights of Transferees?

The differences in the ability and extent of transferring interests in LLPs and LLCs are more “form over substance” than any meaningful legal distinction. In the context of an LLP, a partner may only transfer the partner’s share of profits and losses in the LLP, and the partner’s right to receive a distribution.<sup>35</sup> Thus, the transfer of a partnership interest does not entitle the transferee to participate in the management of the LLP, access information concerning LLP transactions, or inspect the LLP’s books and records.<sup>36</sup>

The transfer of a member’s interest in an LLC is quite similar, as the member may only transfer his “distributional” interest in the LLC, which is akin to a partner’s interest in the LLP.<sup>37</sup> The LLC Act provides, however, that a transferee of such a distributional interest may become a member if the LLC’s Operating Agreement so provides (and the member granted such right as part of the transfer) or if all other members in the LLC so consent.<sup>38</sup> There is no similar provision under RUPA.

On its face, then, one might conclude that the LLC Act provides the potential for a greater opportunity to transfer interests, since it expressly provides a mechanism for the transfer of a member’s entire interest, not just the member’s distributional interest. This conclusion would be hasty, however, since the partners to an LLP can always simply consent to the addition of a new partner, so the transferee of a partnership interest could also become a full partner if the other partners so consent – just like in the LLC context.<sup>39</sup> Moreover, the LLP’s Partnership Agreement could also provide for the inclusion of a transferee into the partnership, just as is available under the LLC Act.<sup>40</sup> In other words, simply because the LLC Act contains express provisions detailing circumstances in which a transferee may become a member, the absence of similar provisions in RUPA does not mean that such events are barred. Consequently, the transferability of interests in the LLC and LLP contexts are virtually identical.

Under both the LLC Act and RUPA, a transferee has certain rights, but they are not the same rights as a member or partner. Instead, the transferee is limited to (i) receive distributions to which the

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transferor would otherwise be entitled; (ii) receive, upon dissolution and wind-up of the entity, amounts otherwise distributable to the transferor; and (iii) seek a judicial determination that it is equitable to wind-up the entity's business.<sup>41</sup>

With respect to this latter right, our research has found no cases interpreting the circumstances of when it would be equitable for a transferee to obtain judicial wind-up an entity's business. That said, the commentary to the model Uniform Limited Liability Company Act, which provides the basis for the Illinois LLC Act, indicates that certain rights of members to effectuate dissolution may be available to transferees under the "equitable" theory, such as where the economic purpose of the LLC is unreasonably frustrated, it is no longer reasonably practicable to carry on the LLC's business, or those in control of the LLC have acted in an illegal, oppressive, or fraudulent manner.<sup>42</sup> Although no similar provision exists in the model Uniform Partnership Act, logic dictates that a transferee of a partnership interest would be afforded similar protections.

### Differences in Creditors' Rights Under Charging Orders?

A charging order is a judicially imposed unsecured lien on a judgment debtor's interest in an LLP or LLC, which entitles the judgment creditor to receive those distributions that would otherwise be made to the judgment debtor.<sup>43</sup> A charging order is the exclusive remedy by which a judgment creditor may satisfy its judgment out of the judgment debtor's interest in an LLP or LLC, and there are no material differences affecting creditors of an interest in one type of entity over the other.<sup>44</sup> In either circumstance, where an entity makes no distribution, the judgment creditor will not receive any funds in satisfaction of its judgment.

The judgment creditor, however, is not entirely without remedy where the entity abstains from making distributions to its partners or members. Both RUPA and the LLC Act authorize a judgment creditor to seek (i) a court-ordered foreclosure and sale of the charged interest, or (ii) the appointment of a receiver over the charged interest.<sup>45</sup> If a judgment creditor seeks foreclosure, the judgment creditor may purchase the interest at the sale, thereby transforming itself to the status of "transferee," with all of the rights of a transferee noted in the previous section.<sup>46</sup> Before the foreclosure actually occurs, however, the judgment debtor, the remaining members/partners, or, if

permitted by the governing document, the entity itself may redeem the charged interest so that foreclosure does not occur.<sup>47</sup>

### Differences in Events Causing Dissolution and Wind Up?

By and large, the provisions regarding the dissolution and wind up of an LLP and LLC are substantially the same, taking into account certain language differences based on the differing nature of the entities.<sup>48</sup> One exception, however, may be found where a member decides to "dissociate" himself from an LLC. In such circumstance, the LLC has an obligation to purchase the dissociated member's distributional interest in the LLC and, if it fails to do so, the dissociated member may petition the court for the LLC's dissolution.<sup>49</sup> By contrast, in the LLP context, although there exists the same obligation to purchase a dissociated partner's interest in an LLP, the dissociated partner does not have the right to petition the court for the LLP's dissolution if it fails to purchase the partner's interest.<sup>50</sup> Rather, in such circumstances, the dissociated partner may obtain a judgment for the value of the partner's interest, plus an award of attorneys' fees and expenses if the failure to tender the purchase amount was not in good faith.<sup>51</sup>

### Conclusion

The analysis contained in this article reveals that LLPs and LLCs, if not identical twins, are closely related cousins. Each is virtually indistinguishable from the other in their substantive features, with the only differences lying primarily in form over substance. Even in instances where statutory differences under RUPA or the LLC Act do exist—say, where a member in a *manager*-managed LLC is statutorily absolved from owing fiduciary duties or where members in an LLC can be held personally liable for unlawful distributions—the same or a similar result might be accomplished through non-statutory mechanisms, such as voluntary provisions in a Partnership Agreement or Operating Agreement, through operation of the common law, or through application of other statutes. There are also some relatively minor differences in the initial and annual fees in maintaining each entity.

The sum and substance of the analysis is that if your client seeks to create a small business, with only two or three participants, all of whom desire to partake in management, the better choice

of entity is probably an LLP over LLC. The initial start-up fee is less expensive and the annual fee is either less expensive (in the two person context) or only slightly more expensive (in the three person context), and the LLP arguably provides a better measure of protection against personal liability for unlawful distributions. On the other hand, where there are a large number of participants, where not everyone wants to participate in management, or where the participants want to create multiple entities to insulate assets (such as in a Series LLC), then an LLC is probably better suited for the client. Regardless, conscientious practitioners would be wise to consider an LLP in providing comprehensive advice to their entrepreneurial clients.

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2. By comparison, there were 388,361 foreign and domestic corporations registered and in good standing in Illinois and 85,083 not-for-profits. Interview of Tara Bols, Representative of Illinois Secretary of State, Department of Business Services, Springfield, Illinois (Nov. 18, 2008).

3. The Illinois Limited Liability Company Act may be viewed at 805 ILCS § 180/1-1, *et seq.* The Illinois Uniform Partnership Act, under which LLPs are organized, may be viewed at 805 ILCS § 206/100, *et seq.*

4. See 805 ILCS § 206/100, *et seq.*

5. Rev. Rul. 88-76, 1988-2 C.B. 360.

6. See 805 ILCS § 180/1-1, *et seq.*

7. See 805 ILCS § 206/1001 (Illinois Secretary of State Form UPA-1001); 805 ILCS § 180/5-5 (Illinois Secretary of State Form LLC-5.5).

8. See 805 ILCS § 206/103; 805 ILCS § 180/15-5.

9. See 805 ILCS § 180/15-1.

10. See 805 ILCS § 180/13-5.

11. See 805 ILCS § 180/13-5.

12. See 805 ILCS § 206/301.

13. See 805 ILCS § 206/303.

14. Compare 805 ILCS § 206/101(f) and 805 ILCS § 180/5-1.

15. See 805 ILCS § 206/108.

16. See 805 ILCS § 180/50-10. By contrast, the cost of creating a corporation is \$150 plus a minimum franchise tax of \$25. See 805 ILCS § 5/15.10.

17. See 805 ILCS § 180/37-40.

18. See 805 ILCS § 180/37-40(b).

19. See Nick Marisco, *Current Status of the Series LLC: Illinois Series LLC Improves Upon Delaware Series LLC But Many Open Issues Remain*, WORLD SERVICES GROUP (November 1, 2006), at <<http://www>>.

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worldservicesgroup.com/publications.asp?action=article&artid=1865>; see also Markus May, *Letters to Editor*, ILLINOIS BAR JOURNAL (March 2007), at <<http://www.isba.org/IBJ/mar07lj/114%20Letters.htm>>.

20. See 805 ILCS § 180/50-10 (Illinois Secretary of State Form LLC-5.5(s)).

21. See 805 ILCS § 206/306(c).

22. Compare 805 ILCS § 206/306(c) and 805 ILCS § 180/10-10(a).

23. See Illinois Supreme Court Rule 722(c) (attorneys at firms organized as LLPs or LLCs are not relieved of "personal liability for claims arising out of acts, errors, or omissions in the performance of professional services by the lawyer or any person under the lawyer's direct supervision and control").

24. See 805 ILCS § 206/401(b); 805 ILCS § 180/25-1(a).

25. Compare 805 ILCS § 206/404 and 805 ILCS § 180/15-3(b).

26. See 805 ILCS § 206/404; 805 ILCS § 180/15-3.

27. See 805 ILCS § 206/103(b); 805 ILCS § 180/15-5(b).

28. See 805 ILCS § 180/15-3(g)(1).

29. See 805 ILCS § 180/15-3(g)(2).

30. See 805 ILCS § 180/15-3(g)(3).

31. See *US v. Bayse*, 410 U.S. 441 (1973) (holding that "[f]ew principles of partnership taxation are more firmly established than that no matter the reason for nondistribution each partner must pay taxes on his distributive share").

32. 693 N.E.2d 583 (Ind. Ct. App. 1998).

33. See 805 ILCS § 180/25-30.

34. See 805 ILCS § 180/25-35.

35. See 805 ILCS § 206/502.

36. See 805 ILCS § 206/503(a).

37. See 805 ILCS § 180/30-5.

38. See 805 ILCS § 180/30-10(a).

39. See 805 ILCS § 206/401(i).

40. See 805 ILCS 206/103.

41. See 805 ILCS § 206/502(b); 805 ILCS § 206/801(6); 805 ILCS § 180/30-10(e); 805 ILCS § 180/35-1(5).

42. See UNIFORM LIMITED LIABILITY COMPANY ACT § 801 cmt. (Amended 1996)

43. See 805 ILCS § 206/504(b); 805 ILCS § 180/30-20(b).

44. See 805 ILCS § 206/504(e); 805 ILCS § 180/30-20(e).

45. See 805 ILCS § 206/504(a)-(b); 805 ILCS § 180/30 20(a)-(b).

46. See 805 ILCS § 206/504(b); 805 ILCS § 180/30-20(b).

47. See 805 ILCS § 206/504(c); 805 ILCS § 180/30-20(c).

48. Compare 805 ILCS § 206/801 and 805 ILCS § 180/35-1.

49. See 805 ILCS § 180/35-1(4)(D).

50. See 805 ILCS § 206/701.

51. See 805 ILCS § 206/701(i).