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## The Illinois Limited Liability Company: A Flexible Alternative for Business

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*Chapman & Cutler, Chicago, IL*

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# The Illinois Limited Liability Company: A Flexible Alternative for Business

Scott R. Anderson\*

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## I. INTRODUCTION

After years of searching, business planners have come one step closer to creating the ideal business entity with the development of the limited liability company ("LLC").<sup>1</sup> An LLC is an unincorporated organization that offers the pass-through tax treatment<sup>2</sup> of a partnership<sup>3</sup>

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1. The area of limited liability company law is literally developing daily with new articles, books, and Internal Revenue Service rulings appearing constantly. At this time no publication can keep up with the most recent developments in this area of law. Nonetheless, the more definitive law review discussions of LLCs include Barbara C. Spudis & Michael L. Gravelle, *The Illinois Limited Liability Company Act*, 81 ILL. B. J. 352 (1993), Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992), and Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387 (1991).

The most comprehensive authority on limited liability company law is LARRY E. RIBSTEIN & ROBERT R. KEATINGE, *RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES* (1992). This book not only discusses all relevant LLC state law and federal taxation issues but also includes a sample LLC operating agreement, all of the state LLC statutes, and a prototype LLC statute developed by an ABA subcommittee. Because this book is published in binder form it should remain the most current publication on LLCs.

For a sample LLC operating agreement and sample articles of organization for an LLC managed by designated non-member managers, see J. WILLIAM CALLISON, *PARTNERSHIP LAW AND PRACTICE* §§ 32.19-20 (1992) (based on the Colorado Limited Liability Company Act). One must exercise caution when using the forms in these two publications because state LLC statutes vary greatly, and some provisions of the forms might not be valid under the laws of all states. In particular, the Colorado statute differs significantly in certain respects from the Illinois statute. For a looseleaf publication containing a number of forms for use in LLC transactions, including sample articles of organization and operating agreements, see WILLIAM D. BAGLEY & PHILIP P. WHYNOTT, *THE LIMITED LIABILITY COMPANY: THE BETTER ALTERNATIVE* (3d ed. 1992). Again, Illinois practitioners must be wary when using this publication; the analysis of the Illinois LLC statute in the third printing of this publication is based on the original bill introduced in the Illinois General Assembly and does not account for the amendments made in the Illinois statute as enacted.

Finally, for a comparison of LLCs and S corporations in which the author argues that both entities should qualify for partnership tax treatment and examines alternative taxation schemes, see Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083 (1992). The article also contains an excellent bibliography of publications on LLCs. *Id.* at 1083 n.1.

2. For an explanation of pass-through tax treatment see *infra* text accompanying notes 7-14.

3. It is imperative to distinguish the concept of a partnership as used for tax purposes from the concept of a general or limited partnership organized under state law. States generally recognize three forms of business organizations that can be organized under state law: (1) the corporation; (2) the partnership (both general and limited); and (3) the limited liability company. While slight differences exist between the states, all states recognize the corporation and partnership; only thirty-five states currently recognize the limited liability company.

Although the Internal Revenue Service has consistently taken the position that a state law corporation cannot receive partnership tax treatment under subchapter K of the tax code, see, e.g., Priv. Ltr. Rul. 79-21-084 (Feb. 27, 1979), some state law partnerships and LLCs can be treated as corporations for tax purposes under subchapter C. See I.R.C.

combined with the limited liability that protects owners of a corporation. More particularly, the LLC is a hybrid of the S corporation and the limited partnership.<sup>4</sup> The LLC, however, affords its owners more flexibility than an S corporation and greater protection from liability than a limited partnership. Moreover, in contrast to a limited partnership, an LLC allows active participation in the management of the business by all owners without jeopardizing limited liability.

On September 11, 1992, the Illinois legislature passed the Illinois Limited Liability Company Act<sup>5</sup> ("ILLCA"), thus making Illinois the eighteenth state and first major industrial state to enact legislation allowing limited liability companies. When the Illinois act takes effect on January 1, 1994,<sup>6</sup> it will offer perhaps the most flexible statutory scheme of all the existing state limited liability company statutes and thus will provide judicious planners with one of the most advantageous business tools available in the United States. Whereas some other states' limited liability company statutes contain mandatory pro-

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§§ 761(a) (1988), 7701(a)(3) (Supp. I 1989). This result follows because the tax code defines a subchapter K partnership as an unincorporated organization which is not a corporation, trust, or estate. I.R.C. § 761(a). State law partnerships and LLCs, however, can be deemed to be "associations" under the tax laws and are thereby included in the tax law definition of "corporation." I.R.C. § 7701(a)(3). The manner in which unincorporated state law organizations are classified as either subchapter K partnerships or tax law corporations (i.e., associations) is discussed in part III of this article.

4. For a comparison of the characteristics of the limited liability company and limited partnership, see generally *infra* part IV. An S corporation is a corporation organized under the regular state business corporation statute that has filed with the IRS a statutory subchapter S election and complies with certain requirements mandated by the federal tax code. I.R.C. § 1361 (1988). A corporation that has filed a subchapter S election receives pass-through tax treatment that is similar, but not identical, to partnerships. Compare I.R.C. §§ 1361-79 (1988) with I.R.C. §§ 701-61 (1988). The most significant restrictions on S corporations relate to the ownership structure of the corporation. An S corporation can issue only one class of stock and cannot have more than thirty-five shareholders. See I.R.C. § 1361(b)(1)(A),(D) (1988). Moreover, S corporations may not have as shareholders nonresident aliens, other corporations, partnerships, certain trusts, charitable organizations, or pension plans. I.R.C. § 1361(b)(1)(B),(C) (1988). An S corporation also may not own more than 80% of the stock of another corporation. I.R.C. § 1361(b)(2)(A) (1988). Finally, an S corporation must allocate items of income, gain, loss, deduction, and credit among its shareholders in a *pro rata* fashion; specialized allocations to shareholders according to each shareholder's individual needs are not permitted. See I.R.C. § 1366 (1988). The term "S corporation" is purely a creation of the Internal Revenue Code; the term has no meaning outside of the federal income tax context. Thus, the description of the LLC as a hybrid of the S corporation (a tax classification created by the federal tax code) and the limited partnership (a business entity created by state law) illustrates the interplay between state business entity law and federal tax law with respect to limited liability companies.

5. Illinois Limited Liability Company Act, P.A. 87-1062, 1992 Ill. Laws 2529 (codified at ILL. COMP. STAT. ch. 805, §§ 180/1-1 to 60-1 (West Supp. 1993)).

6. ILL. COMP. STAT. ch. 805, § 180/1-1.

visions governing issues such as management structure, continuation of LLC business after dissolution, and transferability of LLC ownership interests, the Illinois statute generally permits LLCs to adopt the structure and governing provisions that best suit the particular business needs of the LLC.

Although the ILLCA is a boon for the conscientious, it is also a trap for the unwary. LLC organizers cannot take advantage of the ILLCA's flexibility without first carefully considering the potentially detrimental tax classification issues that will arise when a business entity is structured as an LLC under the Illinois statute. The major lure of the LLC over the corporate form lies in the LLC's characterization as a partnership for federal income taxation purposes. This characterization permits pass-through tax liability, which, due to developments in the federal income tax structure, is a considerable advantage over corporate tax classification.<sup>7</sup> Unlike a corporation, a partnership pays no entity-level income tax; rather, items of income, gain, loss, deduction, or credit are "passed-through" to the partners individually.<sup>8</sup> Thus, in a partnership, income is taxed only once, at the individual ownership level.<sup>9</sup>

In contrast, corporate income is taxed twice. First, corporate income is subject to taxation at the entity level at the time it is earned.<sup>10</sup> Moreover, when a corporation pays dividends to its shareholders, the shareholders must also pay individual income tax on the dividends.<sup>11</sup> Therefore corporate income is subjected to double taxation—it is taxed once at the corporate level and is taxed again at the shareholder level.<sup>12</sup> Avoidance of double taxation provides a major incentive in structuring a business entity as an LLC rather than as a corporation. If the mem-

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7. See generally Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 618-25 (1990).

8. See I.R.C. § 701 (1988).

9. See *infra* note 12.

10. I.R.C. § 11 (1988).

11. I.R.C. § 1 (1988 & Supp. IV 1992); I.R.C. § 61(a)(7) (1988) (expressly including dividend income within the definition of "gross income").

12. See Kwall, *supra* note 7, at 614-15. Other business forms, such as S corporations and partnerships, do not usually pay income tax at the entity level. I.R.C. § 1363(a) (1988) (S corporations); I.R.C. § 701 (1988) (partnerships). Instead, the income of those entities is taxed only at the individual owner level. I.R.C. § 1366(a) (1988) (S corporations); I.R.C. § 701 (partnerships). Partnerships have the additional advantage of allowing individual partners to shelter other income through partnership losses and tax credits in many circumstances. See I.R.C. § 702 (1988); see also J. Martin Burke & Michael K. Friel, *Allocating Partnership Liabilities*, 41 TAX L. REV. 173, 174-77 (1986) (explaining how partnership liabilities can create additional basis in a partner's interest in the partnership, and thus increase the partner's deductions for partnership losses).

bers<sup>13</sup> of an LLC are not cautious when structuring the LLC, however, the Internal Revenue Service ("IRS") may tax the LLC as a subchapter C corporation rather than as a subchapter K partnership, and the members will lose the benefit of pass-through taxation.<sup>14</sup> Thus, it is imperative that members use caution when structuring an LLC to ensure that the IRS characterizes the LLC as a partnership rather than a corporation.

This Article provides an introduction to limited liability companies with special emphasis on the provisions of the ILLCA. Part II traces the historical development of the limited liability company. Part III focuses on the fundamental business characteristics which the IRS reviews when characterizing an LLC as either a partnership or a corporation for federal income taxation purposes. Part IV compares Illinois LLCs with Illinois business corporations, Illinois limited partnerships, and Illinois general partnerships, and discusses the advantages and disadvantages of these business forms in relation to the limited liability company.

## II. THE DEVELOPMENT OF THE LIMITED LIABILITY COMPANY

The origins of the limited liability company in the United States date back to the late 1800s when Pennsylvania, Michigan, New Jersey, and Ohio created a business entity known as the "partnership association."<sup>15</sup> Partnership associations are unincorporated organizations in which the owners are not personally liable for the obligations of their association.<sup>16</sup> Plagued by uncertain federal tax classification,<sup>17</sup> partnership associations were adopted in few states and never gained widespread popularity.<sup>18</sup>

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13. The owners of an LLC are referred to as "members." See ILL. COMP. STAT. ch. 805, § 180/1-5.

14. See *supra* note 3. Partnership tax treatment is determined using a four-part test under the Treasury Regulations that generally takes into consideration whether an organization more resembles the typical state law corporate form or the typical state law partnership form. See *infra* part III.

15. Keatinge, *supra* note 1, text accompanying n.26 at 381; Gazur & Goff, *supra* note 1, at 393. For a detailed discussion of these entities see Edward R. Schwartz, *The Limited Partnership Association—An Alternative to the Corporation for the Small Business with "Control" Problems?*, 20 RUTGERS L. REV. 29 (1965).

16. See Keatinge, *supra* note 1, at 381-82.

17. The United States did not have a federal income tax at the time the original limited partnership association statutes were created. Therefore, unlike LLCs, these entities were not created for tax advantages. Gazur & Goff, *supra* note 1, at 393.

18. Gazur & Goff, *supra* note 1, at 394. Limited liability companies have existed for several years in various European and South American countries. See, e.g., Priv. Ltr. Rul. 82-21-136 (Feb. 26, 1982) (discussing the German "Gesellschaft mit beschränkter Haftung" (GmbH)); Priv. Ltr. Rul. 78-17-129 (Jan. 30, 1978) (discussing the Brazilian

Other entities offering corporate limited liability and pass-through tax status, such as the S corporation and the limited partnership, have found widespread acceptance in the United States. However, in certain situations, these entities have not offered the desired level of flexibility in relation to ownership, distributions, capital structure and participation in the management and control of the business.<sup>19</sup>

In 1977, nearly one hundred years after the enactment of the original legislation allowing partnership associations, Wyoming became the first state in the nation to adopt LLC legislation.<sup>20</sup> Florida followed Wyoming's lead five years later.<sup>21</sup> In addition to Illinois, thirty-three states<sup>22</sup> have now adopted LLC legislation, and several other states are currently considering limited liability company legislation.<sup>23</sup> Thus, although the LLC's predecessor, the limited partnership association,

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"Limitada"); Priv. Ltr. Rul. 78-26-023 (Mar. 28, 1978) (discussing the Portuguese "sociedade por quotas de responsabilidade limitada"). See also Gazur & Goff, *supra* note 1, at 394 & n.32. These foreign companies substantively resemble LLCs currently in use in the United States, but have never been used extensively in the United States. Brian L. Schorr & Aileen R. Leventon, *Limited Liability Company: An Alternative Business Form*, 205 N.Y.L.J. 1 n.13 (1991).

19. See *supra* note 4; *infra* note 231 and accompanying text.

20. Wyoming Limited Liability Company Act, 1977 Wyo. Sess. Laws 158 (codified at WYO. STAT. §§ 17-15-101 to -136 (1989)).

21. Florida Limited Liability Company Act, 1982 Fla. Laws ch. 82 (codified at FLA. STAT. ANN. §§ 608.401 to .471 (West 1993)); see also Richard Johnson, Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387 (1983).

22. See ALA. CODE §§ 10-12-1 to 61 (1993); ARIZ. REV. STAT. ANN. §§ 29-601 to 857 (West Supp. 1993); 1993 Ark. Acts 1003; COLO. REV. STAT. ANN. §§ 7-80-101 to 913 (West Supp. 1992); 1993 Conn. Pub. Acts 93-267; DEL. CODE ANN. tit. 6, §§ 18-101 to 1106 (Supp. 1992); FLA. STAT. ANN. §§ 608.401 to .471 (West 1993); GA. CODE ANN. §§ 14-11-100 to 1109 (Michie Supp. 1993); IDAHO CODE §§ 53-601 to 672 (Michie 1993); IND. CODE ANN. §§ 23-18-1-1 to 13-1 (West Supp. 1993); IOWA CODE ANN. §§ 490A.100 to .1601 (West Supp. 1993); KAN. STAT. ANN. §§ 17-7601 to 7651 (Supp. 1992); LA. REV. STAT. ANN. §§ 1301-69 (West Supp. 1993); MD. CORPS. & ASS'NS CODE §§ 4A-101 to 1103 (Michie 1993); MICH. COMP. LAWS ANN. §§ 450.4101 to .5200 (West Supp. 1993); MINN. STAT. ANN. §§ 322B.01 to .955 (West Supp. 1993); 1993 Mo. Legis. Serv. S.B. 66 & 20 (Vernon); 1993 Mont. Laws 120; 1993 Neb. Laws L.B. 121; NEV. REV. STAT. ANN. §§ 86.011 to .571 (Michie Supp. 1991); 1993 N.H. Laws 313; 1993 N.J. Sess. Law Serv. 210 (West 1993); N.M. STAT. ANN. §§ 53-19-1 to 74 (Michie 1993); 1993 N.D. Laws S.B. 2222; OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West Supp. 1993); 1993 Or. Laws 173; R.I. GEN. LAWS §§ 7-16-1 to 75 (Michie 1993); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to 59 (1993); TEX. REV. CIV. STAT. ANN. Art. 1528n, arts. 1.01-9.02 (West Supp. 1993); UTAH CODE ANN. §§ 48-2b-101 to 157 (1992 & Supp. 1992); VA. CODE ANN. §§ 13.1-1000 to 1073 (Michie 1993); W. VA. CODE §§ 31-1A-1 to 69 (Supp. 1992); WYO. STAT. §§ 17-15-101 to 136 (1989).

23. California (S.B. 469, 1993-94 Sess.), Massachusetts (S.B. 1543, 178th Gen. Assembly, 1993 Sess.), New York (S.B. 27, 215th Gen. Assembly, 1st Sess.), Ohio (S.B. 74, 120th Gen. Assembly, 1993-94 Sess.), and Pennsylvania (H.B. 1719, 176th Gen. Assembly, 1993-94 Sess.) currently are considering legislation creating limited liability company statutes.

and, initially, the LLC itself,<sup>24</sup> faced uncertain tax treatment by the IRS and the Treasury Department, LLC legislation now appears to be sweeping through state legislatures.

In 1980, in its first opinion regarding a state LLC statute, the IRS issued a private letter ruling stating that it would classify a Wyoming LLC as a partnership for tax purposes.<sup>25</sup> At the same time, however, the IRS proposed new regulations that would deny partnership classification to any organization, such as an LLC, in which all members were not personally liable for the organization's debts.<sup>26</sup> In the face of substantial criticism, the IRS recanted its proposals and undertook a six-year study to determine the proper course for the classification issue.<sup>27</sup> With the tax status of LLCs still uncertain, acceptance of LLCs spread sluggishly until 1988.<sup>28</sup>

The IRS finally completed its six-year study and concluded that the characteristic of limited liability alone should not preclude partnership tax classification.<sup>29</sup> Accordingly, in Revenue Ruling 88-76,<sup>30</sup> the IRS adopted the position that a Wyoming LLC would be classified as a partnership for federal income taxation purposes.<sup>31</sup> Although Revenue Ruling 88-76 addressed an LLC with a basic structure that closely followed the provisions of the Wyoming statute,<sup>32</sup> it created sufficient confidence throughout the states to accept the limited liability company as a viable alternative business form.<sup>33</sup> Thus, the IRS's conclusion in 1988 that LLCs could be classified as partnerships for federal income taxation purposes despite their limited liability feature, proved to be the spark that eventually led to the current explosion of LLC legislation.

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24. See Gazur & Goff, *supra* note 1, at 390.

25. See Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980); see also Keatinge, *supra* note 1, at 383 n.37.

26. See Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,709 (1980); see also Keatinge, *supra* note 1, at 383 n.38.

27. See Keatinge, *supra* note 1, at 383 nn.39-40.

28. See Gazur & Goff, *supra* note 1, at 390 & n.10. (noting that as of 1988, only Florida and Wyoming had adopted statutes specifically permitting LLCs).

29. See Announcement 88-118, 1988-38 I.R.B. (Sept. 19, 1988); see also Keatinge, *supra* note 1, at 384 n.48.

30. 1988-2 C.B. 360.

31. *Id.*; see also Gazur & Goff, *supra* note 1, at 390; Keatinge, *supra* note 1, at 384 n.49.

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

33. See Keatinge, *supra* note 1, at 384 nn.51-58; Gazur & Goff, *supra* note 1, at 390; *supra* note 22.



### III. AN ASSESSMENT OF THE FUNDAMENTAL CHARACTERISTICS OF THE LLC UNDER THE INTERNAL REVENUE CODE

The most advantageous aspect of structuring a business entity as an LLC rather than as a corporation is to gain the pass-through federal income tax liability to which partnerships are entitled.<sup>34</sup> In turn, the issue of whether the IRS will tax a business entity as a corporation or a partnership hinges on whether the entity exhibits certain characteristics that are common to corporations, but are usually absent from partnerships.<sup>35</sup> The Treasury Regulations specify that the four characteristics distinguishing a corporation from a partnership are: (1) continuity of life; (2) limited liability; (3) free transferability of interests; and (4) centralization of management.<sup>36</sup> An entity will not receive corporate tax treatment unless the corporate characteristics outweigh the non-corporate characteristics.<sup>37</sup> Accordingly, if a limited liability company possesses fewer than three of the four corporate characteristics, the organization will be classified as a partnership for tax purposes and the members will benefit from pass-through tax liability.

The benchmark for LLC tax classification is Revenue Ruling 88-76.<sup>38</sup> The LLC addressed in Revenue Ruling 88-76 had twenty-five members, including A, B, and C, who were elected managers of the LLC; no member or manager was personally liable for any debt, obli-

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34. *See supra* part I.

35. *See* Treas. Reg. § 301.7701-2(a)(1)-(2) (as amended in 1993).

36. Treas. Reg. § 301.7701-2(a)(1),(2). Although the Treasury Regulations identify six characteristics that are common to corporate entities, Treas. Reg. § 301.7701-2(a)(1), two of these characteristics are also common to partnerships, and thus are not to be considered in determining whether an entity is a partnership or corporation for federal income tax purposes. *See* Treas. Reg. § 301.7701-2(a)(2); *see also* Larson v. Commissioner, 66 T.C. 159 (1976) (discussing and applying each determining characteristic in detail).

The United States Supreme Court first identified several of these factors in *Morrissey v. Commissioner*, 296 U.S. 344 (1935). In *Morrissey*, the Court determined that to distinguish a trust from an association (essentially a corporate entity for federal income tax purposes), it was necessary to consider whether the entity exhibited the following corporate characteristics: (1) centralized control; (2) continuity of life; (3) limited liability; and (4) transferability of ownership. *Id.* at 360; *accord* Larson, 66 T.C. at 159.

37. Treas. Reg. § 301.7701-2(a)(3).

38. Rev. Rul. 88-76, 1988-2 C.B. 360. The IRS recently issued seven more Revenue Rulings classifying LLCs as partnerships for federal income tax purposes. *See* Rev. Rul. 93-53, 1993-26 I.R.B. 7 (addressing a Florida LLC); Rev. Rul. 93-50, 1993-25 I.R.B. 13 (addressing a West Virginia LLC); Rev. Rul. 93-49, 1993-25 I.R.B. 11 (addressing an Illinois LLC); Rev. Rul. 93-38, 1993-21 I.R.B. 4 (addressing a Delaware LLC); Rev. Rul. 93-30, 1993-16 I.R.B. 4 (addressing a Nevada LLC); Rev. Rul. 93-6, 1993-3 I.R.B. 8 (addressing a Colorado LLC); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (addressing a Virginia LLC).

gation, or liability of the LLC.<sup>39</sup> In accordance with the Wyoming statute, the LLC would dissolve upon the death, resignation, retirement, bankruptcy, expulsion, or dissolution of a member, or the occurrence of any other event that terminated the continued membership of a member in the LLC, unless the members unanimously agreed to continue the business.<sup>40</sup> Furthermore, the LLC's members could transfer or assign their ownership interests to a non-member, but the non-member would not acquire the right of a member to participate in the management of the LLC unless all of the remaining members consented to the transfer.<sup>41</sup> If the remaining members refused to consent to the transfer, the transferee would receive only the right to share in the LLC's profits.<sup>42</sup> Based on these characteristics, the IRS ruled that the LLC would be treated as a partnership for federal income tax purposes.<sup>43</sup>

Recently, in the first revenue ruling addressing an LLC to be organized under the Illinois limited liability company statute, the IRS ruled that an Illinois LLC would be treated as a partnership for purposes of federal income taxation.<sup>44</sup> The IRS indicated, however, that because of the flexibility provided by the ILLCA, the tax classification of Illinois LLCs will depend upon the particular provisions of the specific LLC's articles of organization and operating agreement.<sup>45</sup> The LLC at issue had twenty-five members, including A, B, and C, who were elected managers of the company pursuant to a provision in the LLC's articles of organization.<sup>46</sup> In accordance with the ILLCA, the members of the LLC were personally liable to the same extent that a shareholder of an Illinois corporation would be liable in analogous circumstances.<sup>47</sup> Moreover, the LLC's operating agreement stipulated that the LLC would dissolve upon the occurrence of any event which terminated the continued membership of a member, unless within ninety days of the dissolution event, all remaining members of the LLC agreed to continue the business.<sup>48</sup> The LLC's members could also assign or transfer their ownership interests to non-members; the

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39. Rev. Rul. 88-76, 1988-2 C.B. at 360-61.

40. *Id.* at 361.

41. *Id.*

42. *Id.*

43. *Id.*

44. Rev. Rul. 93-49, 1993-25 I.R.B. 11.

45. *Id.* at 13.

46. *Id.* at 11.

47. *Id.* For further discussion of the liability of LLC members and corporate shareholders under Illinois law, see *infra* notes 91, 208-14 and accompanying text.

48. Rev. Rul. 93-49, 1993-25 I.R.B. at 12.

assignee or transferee would not acquire all the attributes of the transferor member's interest, however, unless all the remaining members approved the assignment or transfer.<sup>49</sup>

Based on these provisions in the LLC's articles and operating agreement, the IRS found that the LLC possessed the corporate characteristics of limited liability and centralized management.<sup>50</sup> Because the LLC did not possess more corporate than non-corporate characteristics, the IRS ruled that the LLC would be treated as a partnership for federal income tax purposes.<sup>51</sup>

The following four sections examine each of the four corporate characteristics under various states' limited liability company statutes and consider how each factor relates to federal tax classification. Although the focus of this discussion is on Illinois law, because of the lack of comprehensive IRS rulings interpreting LLCs organized under the ILLCA, the law of other states is also examined to interpret how the IRS may treat Illinois LLCs in the future.

#### A. *Continuity of Life*

An entity possesses the corporate characteristic of continuity of life if the death, insanity, bankruptcy,<sup>52</sup> retirement, resignation, or expulsion of any member (collectively known as "dissolution events") will not cause a dissolution of the entity.<sup>53</sup> The Treasury Regulations stipulate that a dissolution occurs where there is "an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law."<sup>54</sup> Although the remaining members may enter into agreements ("continuation agreements") to continue the business upon the occurrence of a dissolution event, a continuation agreement does not create continuity of life if it requires the approval of at least a majority in interest (not in number) of the remaining members.<sup>55</sup>

Many states have placed a statutory maximum (generally 30 years) on the duration of an LLC.<sup>56</sup> In contrast, Illinois does not impose any

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49. *Id.*

50. *Id.* at 13.

51. *Id.*

52. For a discussion of the implications LLCs raise in bankruptcy, see Note, *Member Bankruptcy under the New Minnesota Limited Liability Company Act: An Executory Contract Analysis*, 77 MINN. L. REV. 953 (1993).

53. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).

54. Treas. Reg. § 301.7701-2(b)(2).

55. See 58 Fed. Reg. 28,501 (1993) (to be codified at 26 C.F.R. § 301.7701-2(b)(1)).

56. See e.g., COLO. REV. STAT. ANN. § 7-80-204(1)(b) (West Supp. 1992); FLA. STAT. ANN. § 608.407(1)(b) (West 1993); WYO. STAT. § 17-15-107(a)(ii) (1989).

fixed limit on duration.<sup>57</sup> The existence or absence of a statutory provision setting forth a maximum period of duration, however, is not determinative of whether an entity has continuity of life.<sup>58</sup> Although a stated duration in an LLC organizing agreement may create a presumption of continuity,<sup>59</sup> if any member has the power to dissolve the organization under local law notwithstanding the existence of the agreement, there is no continuity.<sup>60</sup> Because the Treasury Regulations do not treat a fixed period of duration as determinative of whether an entity has continuity of life,<sup>61</sup> an entity will be found to have the corporate characteristic of continuity only in the absence of a power under local law to dissolve the corporation.<sup>62</sup> Conversely, if a member has the power to dissolve the organization under local law notwithstanding any agreement to continue the LLC, there is no continuity.<sup>63</sup>

Illinois LLCs closely following the statutory provisions should never possess continuity of life.<sup>64</sup> ILLCA section 35-1 provides that an LLC will dissolve upon the happening of the first to occur of any of

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57. Illinois LLCs may stipulate a fixed period of duration in the articles of organization or operating agreement if the members desire to set a fixed period. *See* ILL. COMP. STAT. ch. 805, § 180/35-1(1). The articles of organization are the governing provisions filed with the Secretary of State in order to form a limited liability company. *See* ILL. COMP. STAT. ch. 805, § 180/1-5. The articles of organization are analogous to a corporation's articles of incorporation in form. An operating agreement is a valid agreement of the members that relates to the affairs of an LLC and the conduct of its business. *See* ILL. COMP. STAT. ch. 805, § 180/1-5. An LLC operating agreement is similar in form to a corporation's by-laws or a partnership agreement, although it generally will be more analogous to a partnership agreement than to corporate by-laws in substance. Although Illinois' lack of a limitation on duration does not provide any advantage over other state statutes for the purposes of the continuity of life analysis, the Illinois statute is superior because it allows for greater flexibility in long-term planning.

58. *See* Treas. Reg. § 301.7701-2(b)(3) ("[I]f the agreement provides that the organization is to continue for a stated period . . . the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement.").

59. *Id.*

60. *Id.*

61. *Id.*

62. Treas. Reg. § 301.7701-2(b)(3) (stating that if the agreement establishing an organization "provides that the organization is to continue for a stated period . . . the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement").

63. *Id.*

64. *See* Rev. Rul. 93-49, 1993-25 I.R.B. 11. LLCs that depart from the statutory default provisions, however, still might possess continuity of life. *See infra* notes 75-82 and accompanying text.

In the context of this article, a default provision is a statutory preference that governs a particular aspect of business organization or operations when the entity's operating agreement or charter is silent with regard to a particular issue.

the following events:

- (1) At the time or upon the happening of events specified in the articles of organization [or operating agreement].
- (2) Upon the agreement of the members, which shall be in writing and, unless otherwise provided in the articles of organization, unanimous.
- (3) Unless provided otherwise in the articles of organization or operating agreement, upon the death, retirement, resignation, bankruptcy, court declaration of incompetence with respect to, or dissolution of, a member or upon the occurrence of any other event that terminates the continued membership of a member in the limited liability company, unless within 90 days after the event there are at least 2 remaining members and all the remaining members agree to continue the business of the limited liability company.
- (4) Entry of a decree of judicial dissolution . . . .<sup>65</sup>
- (5) Administrative dissolution [by the Illinois Secretary of State].<sup>66</sup>

In Revenue Ruling 93-49,<sup>67</sup> the IRS ruled that an Illinois LLC did not possess the corporate characteristic of continuity of life.<sup>68</sup> The

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65. ILL. COMP. STAT. ch. 805, § 180/35-1. ILLCA § 180/35-5 sets forth when judicial dissolution may occur. The statute provides in pertinent part:

On application by or for a member, a court in the county in which the principal place of business of the limited liability company is located may order dissolution of a limited liability company whenever it is not reasonably practical to carry on the business in conformity with the articles of organization or the operating agreement or whenever the managers or members in control of the limited liability company have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent and detrimental to the limited liability company or the petitioning member.

ILL. COMP. STAT. ch. 805, § 180/35-5.

66. ILL. COMP. STAT. ch. 805, § 180/35-1. ILLCA § 180/35-25 provides that the Secretary of State may dissolve a limited liability company where: (1) the LLC fails to file its annual report and pay its fee in a timely manner; (2) the LLC fails to file any required report with the Secretary of State in a timely manner; or (3) the LLC fails to appoint and maintain a registered agent in Illinois. ILL. COMP. STAT. ch. 805, § 180/35-25.

67. 1993-25 I.R.B. 11.

68. *Id.* at 12. Prior to this revenue ruling, the IRS had issued two private letter rulings regarding an Illinois LLC. *See* Priv. Ltr. Rul. 93-33-032 (May 24, 1993); Priv. Ltr. Rul. 93-25-039 (March 26, 1993). Both letter rulings addressed the same LLC. The earlier ruling, however, contained an error regarding the issue of continuity of life and was subsequently withdrawn. In Private Letter Ruling 93-25-039, the IRS ruled that the LLC at issue lacked continuity of life, despite the inclusion of a provision in the LLC's operating agreement stating that upon dissolution, the remaining members could continue the business only if two-thirds *in number* of the remaining members voted to do so. This conclusion was incorrect under the Treasury Regulations. *See* 58 Fed. Reg. 28,501 (1993) (to be codified at 26 C.F.R. § 301.7701-2(b)(1)). Private Letter Ruling 93-33-

LLC's operating agreement followed the language of the default provision of ILLCA section 180/35-1(3), stating that the LLC would dissolve upon the occurrence of any dissolution event unless all remaining members agreed within ninety days to continue the business.<sup>69</sup> The IRS ruled that under the Treasury Regulations, even such an agreement would not establish continuity of life if, under local law, the death or withdrawal of a member would cause dissolution.<sup>70</sup> Therefore, the IRS looked to the applicable local law—the ILLCA—and the LLC's operating agreement.<sup>71</sup> The IRS concluded that because there could be no assurance that all remaining members would vote to continue the organization after a dissolution event, as was required by both the statutory default provision and the LLC's operating agreement, continuity of life was not assured.<sup>72</sup> Accordingly, the IRS concluded that the organization lacked the corporate characteristic of continuity of life.<sup>73</sup>

Based on Revenue Ruling 93-49, it is clear that the inclusion of a provision allowing the remaining members of an Illinois LLC to continue the business upon the occurrence of a dissolution event will not alone jeopardize partnership tax classification if the unanimous agreement of the remaining members is required.<sup>74</sup> The ILLCA however,

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032 supersedes the earlier ruling and contains a correct statement of the law under the Treasury Regulations. In Private Letter Ruling 93-33-032, the dissolution provision stated that following dissolution, the remaining members could continue the business upon the approval of two-thirds in number of all owners, *which must also constitute a majority in interest of all remaining owners*. This ruling conforms to the rule stated in the Treasury Regulations. See 58 Fed. Reg. 28,501 (1993) (to be codified at 26 C.F.R. § 301.7701-2(b)(1)).

69. Rev. Rul. 93-49, 1993-25 I.R.B. at 12.

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*; see also Rev. Rul. 93-6, 1993-3 I.R.B. 8 (addressing a Colorado LLC). Although the Colorado statute contains the same type of dissolution provision as the ILLCA, the Colorado statute differs from ILLCA § 180/35-1 in one material respect. The Colorado act stipulates that the subsection (1)(c) right to continue upon a dissolution event must be stated in the articles of organization, whereas ILLCA § 180/35-1(3) is effective regardless of whether this right to continue is specifically stated in the articles. Compare ILL. COMP. STAT. ch. 805, § 180/35-1(3) with COLO. REV. STAT. ANN. § 7-80-801.

74. The lack of a provision in a state LLC statute setting forth a time period in which members may agree to continue the company after a dissolution event has occurred apparently will not affect this conclusion. In Revenue Ruling 93-5, 1993-3 I.R.B. 6, the Internal Revenue Service considered a Virginia LLC organized under the Virginia Limited Liability Company Act, VA. CODE ANN. §§ 13.1-1000 to 1073 (Michie 1993). Similar to the Illinois and Colorado statutes, the Virginia statute permits the members to agree to continue the company after a dissolution event has occurred. Unlike the Illinois and Colorado statutes, the Virginia statute does not provide any time period within

permits Illinois LLCs to provide for the continuation of the company upon the occurrence of a dissolution event by the agreement of less than a unanimous vote of the members.<sup>75</sup> Although the impact of such flexibility was uncertain for some time,<sup>76</sup> recent amendments to the

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which members must reach this agreement. Compare VA. CODE ANN. § 13.1-1046 with ILL. COMP. STAT. ch. 805, § 180/35-1 and COLO. REV. STAT. ANN. 7-80-801. In Revenue Ruling 93-5, the IRS used the same reasoning as in Revenue Ruling 93-6 and concluded that the Virginia LLC did not exhibit continuity of life because the unanimous agreement of all remaining members could not be assured. 1993-3 I.R.B. at 8. In reaching this conclusion, the IRS did not even mention that the Virginia statute lacked a provision limiting the time period in which the remaining members must reach this agreement. *Id.* See also Revenue Ruling 88-76, 1988-2 C.B. 360 (concluding that Wyoming LLC did not possess continuity of life but failing to consider that the Wyoming Limited Liability Company Act does not limit the time in which remaining members must agree to continue an LLC after a dissolution event).

75. The introductory clause of ILLCA § 180/35-1(3) allows an Illinois LLC to adopt such a provision in its articles of organization or operating agreement. The statute provides that dissolution occurs upon any dissolution event unless the remaining members unanimously agree to continue the company, "[u]nless provided otherwise in the articles of organization or operating agreement." ILL. COMP. STAT. ch. 805, § 180/35-1(3) (emphasis added). The two "unless" clauses in this provision are somewhat confusing. See *supra* text accompanying note 65. A more understandable phrasing of the introductory clause might have been, "Except as otherwise provided in the articles of organization or operating agreement . . ." instead of the current introductory clause, "Unless provided otherwise . . ." The meaning appears to be the same in either case.

76. In a 1989 private letter ruling, the IRS ruled that a Florida LLC possessed continuity of life solely because the articles of organization provided that a dissolution event would cause the LLC to terminate unless the members agreed to continue the LLC by a majority vote. See Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989). The IRS did not explicitly provide the reasoning behind this conclusion, but the private letter ruling suggests that the IRS found continuity because the agreement required the consent of only the majority, rather than the unanimity, of members. *Id.*

The trend in IRS determinations subsequent to this 1989 private letter ruling, however, suggested that the IRS had changed its position on this issue. In Private Letter Ruling 92-26-035, the LLC's operating agreement provided that upon the occurrence of a dissolution event, the remaining members had a right to continue the business of the LLC if, within ninety days of a dissolution event, all the remaining managers and a majority in voting interest and in number of the remaining members gave their consent. Priv. Ltr. Rul. 92-26-035 (March 26, 1992). The IRS found that the LLC did not possess continuity of life. *Id.*

Subsequently, the IRS adopted Revenue Procedure 92-35, which stated that the IRS would find that an organization lacks continuity of life if under state law and the operating agreement, the bankruptcy or removal of a member would cause a dissolution unless the remaining members or *at least a majority* in interest of the remaining members agree to continue the business. See Rev. Proc. 92-35, 1992-18 I.R.B. 21, 22. Thereafter, in Private Letter Ruling 93-08-027 (Nov. 27, 1992), the IRS addressed an LLC whose operating agreement provided that the company would dissolve upon the occurrence of any dissolution event unless, within 90 days of the event, a majority of the managers and a majority in interest and in number of the remaining members agreed to continue the company. *Id.* The IRS took the position that the LLC lacked continuity of life. *Id.*

These rulings did not clearly indicate whether the IRS maintained its position that a majority-consent continuation agreement would cause an LLC to possess continuity of

Treasury Regulations now conclusively define the conditions under which a less-than-unanimous continuation agreement will cause an LLC to possess the corporate characteristic of continuity of life.<sup>77</sup>

Under the amended Treasury Regulations, a continuation agreement among the members of an LLC will not cause continuity of life to exist, notwithstanding the fact that the dissolution of the LLC may be avoided, if *at least a majority in interest* of the remaining members agree to continue the LLC following a dissolution event.<sup>78</sup> Ten days after the amendment took effect, the IRS considered how this new regulation applied to an Illinois LLC.<sup>79</sup> The LLC's operating agreement provided that the members could continue the business of the LLC upon the written approval of two-thirds of all remaining members, so long as they comprise a majority in interest of all remaining members.<sup>80</sup> The IRS concluded that the LLC did not possess continuity of life.<sup>81</sup>

It is important to recognize that private letter rulings do not carry precedential value for other taxpayers; rather, these rulings are issued to and address only the taxpayer who requested the ruling.<sup>82</sup> Thus, letter rulings merely provide an indication of how the IRS might treat a

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life. The recent amendments to the Treasury Regulations conclusively answer this question in the negative. See 58 Fed. Reg. 28,501 (1993) (to be codified at 26 C.F.R. § 301.7701-2(b)(1)); *infra* text accompanying notes 78-82. Foreshadowing the change in law, just prior to the date on which the amendments were officially adopted, the IRS took the position in two private letter rulings that majority consent continuation agreements did not cause an LLC to possess continuity of life. See Priv. Ltr. Rul. 93-31-010 (May 5, 1993); Priv. Ltr. Rul. 93-21-047 (Feb. 25, 1993).

77. See *supra* note 55 and accompanying text.

78. 58 Fed. Reg. 28,501 (1993) (to be codified at 26 C.F.R. § 301.7701-2(b)(1)). It is very important to note that Treasury Regulations require a majority *in interest* rather than in number to agree to the continuation of business. See *id.* For example, assume that an LLC has four members: A, who owns a 30% interest; B and C, who each own a 10% interest; and D, who owns a 50% interest. Assume further that D withdraws from the LLC, leaving A with a 60% ownership interest, and B and C each with a 20% ownership interest. To avoid continuity of life, A must agree to continue the business. Because B and C constitute a majority in number, but not a majority in interest, their agreement alone cannot continue the LLC. If the LLC agreement permits them to do this, the IRS will find continuity of life to exist. *Id.*

79. Priv. Ltr. Rul. 93-33-032 (May 24, 1993).

80. *Id.* Note that this ruling superseded an earlier private letter ruling which the IRS had decided contrary to the Treasury Regulations. See *supra* note 68. Private Letter Ruling 93-33-032 contains a correct statement of the IRS's position regarding continuity. Thus, in contrast to what is stated in Private Letter Ruling 93-25-039, even if two-thirds in number of the remaining members agree to continue the business, there is no guarantee that a majority *in ownership interest* will agree, as the Treasury Regulations require. See 58 Fed. Reg. 28,501.

81. Priv. Ltr. Rul. 93-33-032 (May 24, 1993).

82. I.R.C. § 6110(j)(3) (1988).



company in circumstances similar to those addressed in the rulings and do not necessarily govern future IRS determinations. Nevertheless, the amendments to the Treasury Regulations and recent private letter rulings demonstrate that LLCs may safely provide in their articles or organizing agreements that after a termination event, the business may continue with the consent of less than all remaining members, provided that the agreement requires the consent of at least a majority in interest of the remaining members.

### *B. Liability of Members*

Another factor that the IRS considers when characterizing an entity as either a partnership or a corporation is whether the members have limited liability.<sup>83</sup> Limited liability companies, by definition, always possess the corporate characteristic of limited liability.<sup>84</sup> An entity possesses limited liability if "under local law there is no member who is personally liable for the debts of or claims against the organization."<sup>85</sup> A member is "personally liable" if the entity's creditors may obtain payment of organizational liabilities from the member when the assets of the entity are insufficient to satisfy the claim.<sup>86</sup> Since limited liability is an essential characteristic of an LLC, limited liability will always exist.

Members of a limited liability company parallel corporate shareholders in that LLC members are not personally liable for the obligations of the company.<sup>87</sup> In this respect, LLCs differ from general partnerships, in which each partner is jointly and severally liable for partnership obligations.<sup>88</sup> Limited partners in a limited partnership enjoy nearly the same limited liability as LLC members, with one major distinction: Limited partners can be held personally liable, as general partners, for

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83. See Treas. Reg. § 301.7701-2(a)(1) (1980).

84. See e.g., ILL. COMP. STAT. ch. 805, § 180/10-10; Rev. Rul. 93-49; Priv. Ltr. Rul. 93-33-032 (May 24, 1993).

85. Treas. Reg. § 301.7701-2(d)(1).

86. *Id.*

87. See, e.g., FLA. STAT. ANN. § 608.436 (West 1993) ("Neither the members of a limited liability company nor the managers of a limited liability company managed by a manager or managers are liable under a judgment, decree, or order of a court, or in any other manner, for a debt, obligation, or liability of the limited liability company."). Most limited liability company statutes in other jurisdictions have provisions that are identical or substantially similar. See, e.g., COLO. REV. STAT. ANN. § 7-80-705; KAN. STAT. ANN. § 17-7620; WYO. STAT. § 17-15-113. *But see* ILL. COMP. STAT. ch. 805, § 180/10-10 and W. VA. CODE § 31-1A-33, discussed *infra* text accompanying notes 91-102.

88. See, e.g., Illinois Uniform Partnership Act, ILL. COMP. STAT. ch. 805, § 205/15 (West 1992) ("IPA").

entity obligations if they exercise control of the business.<sup>89</sup> In contrast, LLC members generally retain their limited liability regardless of their level of control of LLC business.<sup>90</sup> This aspect of the LLC offers a profound advantage over limited partnerships.

Although the ILLCA provides greater protection from liability than either a general or limited partnership, the Illinois legislature did not accord LLC members greater protection from liability than corporate shareholders. Rather, the legislature specifically provided that an LLC member "shall be personally liable for any act, debt, obligation, or liability of the limited liability company or another member or manager to the extent that a shareholder of an Illinois business corporation is liable in analogous circumstances under Illinois law."<sup>91</sup> Thus, LLC members have the same protection from liability, but no more, than that enjoyed by corporate shareholders. Accordingly, the ILLCA appears to incorporate by reference all relevant Illinois statutes and case law regarding corporate shareholder liability.

Although such a broad provision might give rise to some ambiguity,<sup>92</sup> it does have certain advantages. First, the very text of this provision appears to answer the question of whether the doctrine of piercing the corporate veil should be applied in the LLC context. The statute ties the personal liability of an LLC member for the LLC's actions to the liability that a corporate shareholder incurs for a corporation's actions, thereby implying that all doctrines of corporate shareholder liability under Illinois law will apply to LLCs.<sup>93</sup> Since the doctrine of piercing the corporate veil is well established in the realm of Illinois' law of corporations,<sup>94</sup> ILLCA section 180/10-10 seems to

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89. See, e.g., Illinois Revised Uniform Limited Partnership Act, ILL. COMP. STAT. ch. 805, § 210/303 (West 1992) ("ILPA").

90. See ILL. COMP. STAT. ch. 805, § 180/10-10.

91. ILL. COMP. STAT. ch. 805, § 180/10-10(a). ILLCA § 180/10-10(b) further provides that an LLC manager will be personally liable to the extent that a director of an Illinois corporation would be liable in analogous circumstances. See *infra* notes 178-81 and accompanying text for a further discussion of this provision.

92. For example, there apparently has been some concern as to whether the application of the doctrine of piercing the corporate veil (*i.e.*, holding an owner liable for the entity's liabilities) effectively creates a requirement that LLCs must maintain a certain amount of capital. Corporate shareholders can be held personally liable in some cases when a corporation is inadequately capitalized. See *infra* sources cited note 94. This rule does not have direct application in the context of limited partnerships, which generally do not have any capitalization requirement. See *infra* text accompanying notes 98-102 for an additional example of an ambiguity concerning defective LLC organization.

93. See ILL. COMP. STAT. ch. 805, § 180/10-10(a),(b).

94. "A corporation is a legal entity which exists separate and distinct from its shareholders, officers, and directors." *Gallagher v. Reconco Builders, Inc.*, 415 N.E.2d 560, 563 (Ill. App. Ct. 1980). Generally, the officers and directors are not personally liable

give the doctrine direct application to Illinois LLCs.<sup>95</sup> Second, by holding LLC members personally liable for the liabilities attributable to "another member or manager" only to the extent that a shareholder would be held liable under similar circumstances,<sup>96</sup> ILLCA section 180/10-10 ensures that partnership-type liability, in which one partner is liable for the acts of another partner,<sup>97</sup> does not apply to members of Illinois LLCs.

One question left unanswered by the ILLCA, however, is the liability that attaches to LLC organizers who act without having properly formed an LLC under the ILLCA. Other states that have enacted LLC legislation have expressly provided that "[a]ll persons who assume to act as a limited liability company without authority to do so shall be jointly and severally liable for all debts and liabilities."<sup>98</sup> Although the Illinois Business Corporation Act<sup>99</sup> contains a similar provision,<sup>100</sup> the ILLCA does not. Arguably, ILLCA section 180/10-10 does not apply to persons who have not properly formed an LLC and, therefore, does not protect such persons with limited liability.<sup>101</sup>

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for the corporation's liabilities, debts, and obligations. *Id.* A corporate entity may be disregarded and a natural person may be held personally liable, however, where either (1) the corporation is the alter ego of the director, officer, or shareholder, or (2) maintaining the "fiction" of separation of the corporation from the real party "would sanction a fraud or promote injustice." *People ex rel. Scott v. Pentozzi*, 277 N.E.2d 844, 851 (Ill. 1971) (quoting 19 C.J.S. *Corporations* § 839). *Accord Gallagher*, 415 N.E.2d at 563-64; *Stap v. Chicago Aces Tennis Team, Inc.*, 379 N.E.2d 1298, 1301-02 (Ill. App. Ct. 1978); *Berlinger's, Inc. v. Beef's Finest, Inc.*, 372 N.E.2d 1043, 1048 (Ill. App. Ct. 1978). This doctrine was established in Illinois over a century ago. *See Pentozzi*, 277 N.E.2d at 852.

95. This is significant because statutes in many other jurisdictions have failed to address the same question. In contrast to most states, the Colorado statute explicitly contains a provision requiring courts to apply Colorado case law addressing corporate veil piercing whenever a party seeks to hold members of an LLC personally liable for actions attributable to the LLC. COLO. REV. STAT. ANN. § 7-80-107.

96. *See supra* note 91 and accompanying text.

97. ILL. COMP. STAT. ch. 805, § 205/13.

98. FLA. STAT. ANN. § 608.437; KAN. STAT. ANN. § 17-7621; WYO. STAT. § 17-15-133. *But see* COLO. REV. STAT. ANN. § 7-80-105 (imposing such liability only where the participants acted "without good faith belief that they have such authority").

99. ILL. COMP. STAT. ch. 805, §§ 5/1.01-17.05 (West 1993) ("IBCA").

100. *See* ILL. COMP. STAT. ch. 805, § 5/3.20.

101. This argument turns on a strict adherence to the literal words of the Illinois statute. A person is a "member" of an LLC only if he has "an ownership interest in a limited liability company." ILL. COMP. STAT. ch. 805, § 180/1-5. A "manager," in turn, is "a person elected by the members of a limited liability company." *Id.* An entity can be a "limited liability company," however, only when it is "organized and existing" under the ILLCA. *Id.* Therefore, where there has been a defective formation, an entity, *by definition* cannot be a "limited liability company" under the ILLCA. Accordingly, those who attempted to form the company cannot qualify as "members" or "managers" and thus are not accorded limited liability as such under ILL. COMP. STAT. ch. 805, § 180/10-10.

Nevertheless, given that LLCs are similar in nature to partnerships, a provision in the ILLCA imposing liability for acting without proper formation might be unnecessary because the failed LLC will generally fall within the statutory definition of a partnership, and partnership liability will be imposed on the principals.<sup>102</sup>

### C. *Transferability of Interests*

A third characteristic to which the IRS looks in determining whether to classify an organization as a partnership or corporation for federal income tax purposes is free transferability of interests.<sup>103</sup> The corporate characteristic of free transferability of ownership interests exists where the members of an entity may transfer their entire ownership interest in the entity to non-members without the consent of the other members.<sup>104</sup> Such a transfer occurs when the member transfers all the attributes of her ownership interest in the entity, including her right to participate in management.<sup>105</sup> If a member may transfer her right to share in profits but not her right to participate in management, or if a transfer of interest will cause a dissolution of the organization, free transferability of interests will not exist.<sup>106</sup>

LLCs formed under the first generation of LLC statutes do not possess the corporate characteristic of free transferability. Although the first generation of LLC statutes allow a member to transfer her membership interests, they do not give the transferee or assignee the right to participate in management or become a member unless the existing members, other than the member proposing the transfer, unanimously consent.<sup>107</sup> If unanimous consent is not given, the transferee or assignee merely acquires a right to receive the transferor's share of profits and other compensation, by way of income and return of con-

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102. See ILL. COMP. STAT. ch. 805, § 205/15. For further discussion of this issue, see *infra* text accompanying notes 175-77.

103. See Treas. Reg. § 301.7701-2(a)(1)(1980).

104. *Id.* § 301.7701-2(e)(1).

105. *Id.*

106. *Id.* It is important to note that mere assignment of financial rights in a business entity does not remove the assigning member's right to participate in management. See, e.g., ILL. COMP. STAT. ch. 805, §§ 180/30-5, 30-10. Thus, such a transfer could injure the non-assigning members by reducing the assigning member's incentive to act in the best interest of the company. LLCs can avoid this potential problem in two ways. First, the operating agreement can specify that management rights will terminate upon an assignment of full financial rights. Second, the operating agreement can require some degree of manager or member consent prior to any such assignment. See RIBSTEIN & KEATINGE, *supra* note 1, § 7.05.

107. See, e.g., COLO. REV. STAT. ANN. § 7-80-702; FLA. STAT. ANN. § 608.432; KAN. STAT. ANN. § 17-7618; WYO. STAT. § 17-15-122.

tribution.<sup>108</sup> Directed at tax classification concerns, these provisions mirror partnership characteristics<sup>109</sup> and heavily restrict transferability.<sup>110</sup> Thus, under the Treasury Regulations,<sup>111</sup> LLCs formed pursuant to these statutes do not have free transferability.

Illinois and some other states have enacted more flexible LLC statutory schemes that render the issue of free transferability less certain for tax classification purposes.<sup>112</sup> For example, under the Illinois-type statutes, the interest of a member in a limited liability company is personal property and can be transferred or assigned as provided in the company's articles of organization or operating agreement.<sup>113</sup> In these states, the unanimous consent requirement is merely a statutory default provision that operates in the absence of any controlling provision in the articles or operating agreement.<sup>114</sup> Because the ILLCA permits LLCs to establish their own regulations regarding transferability, Illinois LLCs are free to adopt provisions that permit the transfer of full ownership rights where consent is given by, for example: (i) a majority of the members;<sup>115</sup> (ii) managers only; (iii) a combination of

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108. See, e.g., COLO. REV. STAT. ANN. § 7-80-702; FLA. STAT. ANN. § 608.432; KAN. STAT. ANN. § 17-7618; WYO. STAT. § 17-15-122.

109. See, e.g., ILL. COMP. STAT. ch. 805, § 205/25-27.

110. These restrictions might not affect many closely held companies. Often owners of closely held businesses *desire* transfer restrictions so that they can control who their business partners are. Without transfer restrictions on ownership interests, such as the right of first refusal, business owners could be forced to accept unwanted business partners. Since LLC members must consent to a transfer of another member's ownership rights, LLC members can avoid being forced into doing business with unwanted associates. Those companies desiring increased transferability without jeopardizing partnership tax status face complicated questions that have yet to be answered in the still-developing area of LLC law. See *infra* text accompanying notes 113-32.

111. Treas. Reg. § 301.7701-2(e)(1) (1980).

112. See, e.g., ILL. COMP. STAT. ch. 805, § 180/30-5; DEL. CODE ANN. tit. 6, §§ 18-702 to -704 (Supp. 1992); IOWA CODE ANN. §§ 490A.902 to .903 (West Supp. 1993).

113. See, e.g., ILL. COMP. STAT. ch. 805, §§ 180/30-1 and 30-5; DEL. CODE ANN. tit. 6, §§ 18-701, 18-702 and 18-704 (Supp. 1992); IOWA CODE ANN. §§ 490A.901-.903 (West Supp. 1993).

114. See, e.g., ILL. COMP. STAT. ch. 805, § 180/30-5; DEL. CODE ANN. tit. 6, §§ 18-702 and 18-704; IOWA CODE ANN. §§ 490A.902-.903.

115. While a provision allowing transfer of a member's "complete" interest in the LLC after majority consent, rather than unanimous consent, would allow slightly greater flexibility, the usefulness of such a provision is questionable since consent would still be required prior to a transfer of the member's interest and the likelihood of obtaining the consent of even a majority of members at the time just prior to transfer might be uncertain. The IRS has clearly stated that a provision which allows members to transfer their entire ownership interest without the approval or consent of any other member or manager will cause an LLC to possess the corporate characteristic of free transferability. See Rev. Rul. 93-38, 1993-21 I.R.B. 4, 5. In this respect, advance consent agreements are far more effective.

members and managers; or (iv) advance consent in the articles of organization or operating agreement to certain transfers that meet specific criteria.<sup>116</sup>

In Revenue Ruling 93-49,<sup>117</sup> the IRS ruled that the Illinois LLC at issue lacked the corporate characteristic of free transferability.<sup>118</sup> The LLC's operating agreement provided that members could assign or transfer their membership interests, but that the assignee or transferee would not become a substituted member with full membership rights unless all the remaining members approved the assignment or transfer.<sup>119</sup> Unfortunately, Revenue Ruling 93-49 addressed only a very basic transferability provision and therefore does not indicate the extent to which other customized transferability provisions might jeopardize partnership tax classification.

In recent private letter rulings, the IRS has shed considerable light on the types of transfer schemes that it will permit without finding the corporate characteristic of free transferability to exist. In Private Letter Ruling 92-10-019,<sup>120</sup> the IRS considered an LLC organized under the Texas Limited Liability Company Act,<sup>121</sup> which, like ILLCA section 30-5, permits LLCs to set their own regulations governing the transfer of members' interests.<sup>122</sup> The regulations<sup>123</sup> of the Texas LLC at issue stipulated that a member could not transfer his interest without first obtaining (i) consent of the manager, or (ii) if the manager was not a member or the manager was the member making the transfer, consent of a majority (in interest) of the members.<sup>124</sup> Furthermore, the LLC's regulations contained an advance consent to certain transfers that occur by operation of law, such as transfers upon death, dissolution, divorce, liquidation, and merger, and transfers to certain transferees delineated in the LLC's regulations.<sup>125</sup> The IRS ruled that the LLC

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116. See ILL. COMP. STAT. ch. 805, §180/30-5. Such criteria might include transfers to certain trusts, relatives of members, transferees with certain net worths or incomes, transferees satisfying conditions for exemptions under the securities laws, or transfers occurring by operation of law such as a transfer upon death or in the course of bankruptcy proceedings.

117. 1993-25 I.R.B. 11.

118. *Id.* at 13.

119. *Id.* at 12.

120. Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991).

121. TEX. REV. CIV. STAT. ANN. Art. 1528n (West Supp. 1993).

122. See *id.* art. 4.05A.

123. Under the Texas LLC statute, the "regulations" are the equivalent of an "operating agreement" under the ILLCA. Compare TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 3.02 with ILL. COMP. STAT. ch. 805, §180/15-5.

124. Priv. Ltr. Rul. 92-10-019.

125. *Id.*

lacked the characteristic of free transferability.<sup>126</sup>

Two months later, the IRS confronted the transferability question regarding another Texas LLC.<sup>127</sup> The LLC's regulations provided that no member could transfer her full ownership interest unless consent was given by (i) the manager (who was required to be a member), *or* (ii) members owning at least two-thirds of the ownership interests (excluding the transferred interests).<sup>128</sup> Again, the IRS found that the LLC did not possess free transferability.<sup>129</sup> The following week, the IRS was requested to characterize a Utah LLC whose operating agreement required consent of a majority of the non-transferring members prior to a transfer of a member's full membership rights.<sup>130</sup> The IRS ruled that the Utah LLC lacked free transferability.<sup>131</sup> Based on these private letter rulings, the IRS apparently will find that an LLC lacks free transferability when a member, prior to a transfer of the member's full ownership rights, must obtain consent of (i) the sole manager if the manager is a member of the LLC, or (ii) at least a majority of the non-transferring members.

Although planners must exercise caution when drafting provisions to govern transferability of ownership interests, these private letter rulings indicate that some flexibility exists. The IRS seems to take the position that an LLC lacks free transferability as long as some meaningful impediment to transfer of a member's full interest exists. At the same time, planners must be very careful when using *manager* consent provisions. When an LLC is managed by non-member managers, the LLC is likely to possess centralized management (in addition to limited liability) and may therefore exhibit as many corporate as non-corporate characteristics, placing the LLC's partnership tax status in jeopardy.<sup>132</sup>

One alternative to using the manager consent provisions is to employ a tiered ownership structure. Since LLC statutes permit other organizations to own LLC interests,<sup>133</sup> a tiered ownership structure is

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126. *Id.* The IRS determined that, on balance, the Texas LLC did not have more corporate than non-corporate characteristics, and therefore ruled that the LLC would be treated as a partnership for federal income tax purposes. *Id.*

127. Priv. Ltr. Rul. 92-18-078 (Jan. 31, 1992).

128. *Id.*

129. *Id.* Again, the IRS determined that, on balance, the Texas LLC did not have more corporate than non-corporate characteristics, and therefore ruled that the LLC would be treated as a partnership for federal income tax purposes. *Id.*

130. See Priv. Ltr. Rul. 92-19-022 (Feb. 6, 1992); UTAH CODE ANN. § 48-26-131.

131. *Id.* The IRS concluded that the Utah LLC was to be classified as a partnership for federal income tax purposes. *Id.*

132. See *infra* text accompanying notes 149-54.

133. The LLC statutes typically describe permissible members simply as "persons" and include various entities in that term. See, e.g., ILL. COMP. STAT. ch. 805, § 180/1-5

permitted. Under such a structure, organizations (other than the LLC itself) would act as LLC members. For example, two or more limited partnerships may hold a limited liability company. While members could freely transfer their underlying interests in the limited partnerships, they would rarely, if ever, transfer their LLC interests.

The tiered ownership structure, however, has two primary drawbacks: (i) increased formality and planning; and (ii) uncertain tax classification. Whereas a limited liability company with two corporate members has been classified as a partnership for tax purposes,<sup>134</sup> the IRS has not yet taken a position as to the treatment of a company which, strictly to gain tax benefits, was formed with limited partnerships as members. Some commentators have suggested that based on earlier positions taken by the IRS, tax classification should be applied at each ownership level instead of treating tiered ownership layers together.<sup>135</sup> Should the IRS adopt this position with respect to LLCs, tiered ownership structures would effectively alleviate many problems of restricted transferability. Until the IRS affirmatively takes this position, however, practitioners must use caution when establishing tiered ownership structures.

A recent IRS ruling sheds some light on the use of tiered ownership structures. In Revenue Ruling 93-4,<sup>136</sup> the IRS addressed a German GmbH<sup>137</sup> that had as its sole members two United States corporations. The two corporations were wholly-owned subsidiaries of another United States corporation.<sup>138</sup> The GmbH's memorandum of association (articles of organization) stipulated that the ownership interests were not freely transferable unless the other members approved of the transfer.<sup>139</sup> Nonetheless, the IRS found that the GmbH possessed the characteristic of free transferability because the controlling parent cor-

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(defining "member" as a person and "person" to include the full spectrum of business organizations and other entities).

134. See Priv. Ltr. Rul. 90-30-013 (April 25, 1990) (finding that a Florida LLC lacked free transferability and characterizing the LLC as a partnership for federal income tax purposes).

135. Gazur & Goff, *supra* note 1, at 450-51. This position is based on an IRS ruling relating to a limited partnership that had another limited partnership as its sole general partner. See Priv. Ltr. Rul. 87-53-006 (Sept. 30, 1987) (examining only whether the partnership had continuity of life and limited liability, and concluding that because the partnership did not have either characteristic, it was to be characterized as a partnership for federal income tax purposes).

136. Rev. Rul. 93-4, 1993-3 I.R.B. 5.

137. A "GmbH" is the German equivalent of a U.S. limited liability company. See *supra* note 18.

138. Rev. Rul. 93-4, 1993-3 I.R.B. at 5.

139. *Id.* at 6.



poration could make all the transfer decisions for its wholly-owned subsidiaries.<sup>140</sup> The IRS ruled that "[t]o lack free transferability, the possibility of an impediment to transfer must exist. Because all the members of the GmbH are commonly controlled, consent to transfer is not meaningful . . . ."<sup>141</sup>

Whether Revenue Ruling 93-4 will control tiered ownership structures used in LLCs is uncertain.<sup>142</sup> Revenue Ruling 93-4 does indicate, however, that the IRS will, at least in some circumstances, look beyond each ownership level and examine the effect of the aggregate business enterprise. Revenue Ruling 93-4 emphasizes that great caution must be used when considering tiered ownership structures in the LLC context. Given the IRS's position in the private letter rulings discussed above,<sup>143</sup> tiered ownership structures appear to be a problematic and unattractive way to structure ownership of an LLC.

#### *D. Centralization of Management*

The fourth characteristic to which the IRS looks in characterizing an entity as either a partnership or a corporation is whether there is centralized management.<sup>144</sup> Centralized management exists where "any person (or group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed."<sup>145</sup> Furthermore, the Treasury Regulations provide that centralized management does not exist "unless the managers have sole authority to make the decisions."<sup>146</sup> Thus, an LLC will generally possess centralized management if the company is managed by non-member managers who have unfettered authority to make decisions regarding the LLC's business.

Pursuant to the Treasury Regulations, an LLC might avoid centralized management by requiring members to approve certain business decisions in the operating agreement. LLCs with many members,<sup>147</sup>

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140. *Id.*

141. *Id.* This conclusion reaffirmed the earlier position that the IRS had taken on this issue in Rev. Rul. 77-214, 1977-1 C.B. 408.

142. Contrary to Rev. Rul. 93-4, in Priv. Ltr. Rul. 90-30-013 (April 25, 1990), the IRS ruled that an LLC owned by two corporations that had no common parent lacked free transferability. Private letter rulings, however, do not carry precedential value. I.R.C. § 6110(j)(3) (1988). See *supra* text accompanying note 82.

143. See *supra* text accompanying notes 120-31.

144. See Treas. Reg. § 301.7701-2(a)(1) (1980).

145. *Id.* § 301.7701-2(c)(1).

146. *Id.* § 301.7701-2(c)(4).

147. LLCs held by a large number of members are not the only companies that might

however, will often find it difficult to avoid the corporate characteristic of centralized management because they cannot effectively run their businesses without centralizing management power in the hands of only a few people.

The following three sections focus on the aspects of state law that govern managerial structure and authority of LLCs and discuss relevant tax classification considerations raised by these issues. The first section addresses LLC managerial structures and the implication of various structures on federal tax classification. The second and third sections examine the managerial authority of members and managers under these structures in relation to state law.

### 1. Managerial Structure

Some state LLC statutes, like the ILLCA, contain a default provision that initially vests the management powers of LLCs in the members of the LLC,<sup>148</sup> whereas other states' default provisions initially vest the management powers in managers of the LLC<sup>149</sup> or even require that LLCs be managed by non-member managers.<sup>150</sup> All three types of statutes, however, permit the members to agree in the articles of organization to vest the management powers in all members, in only certain members, or in non-member managers.<sup>151</sup> Although any initial differences among these statutory schemes appear meaningless, a recent IRS revenue ruling<sup>152</sup> has magnified the importance of the distinctions.

In Revenue Ruling 93-6, the IRS addressed an LLC ("M") to be organized under the Colorado Act.<sup>153</sup> The IRS came to the following

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encounter problems as to the centralization of management. For example, a closely-held family company might desire centralized managers because some or all of the members lack sufficient business experience or are not located in close enough proximity to effectively manage the company together.

148. *E.g.*, ILL. COMP. STAT. ch. 805, § 180/15-1 (West Supp. 1992); FLA. STAT. ANN. § 608.422 (West 1992); KAN. STAT. ANN. § 17-7612 (1992); WYO. STAT. § 17-15-116 (1993).

149. *E.g.*, TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.12 (West Supp. 1993).

150. *See, e.g.*, COLO. REV. STAT. ANN. § 7-80-401(1) (West Supp. 1992). Of course, the statute does not prevent all the members of an LLC from being the LLC's sole managers.

151. *See, e.g.*, COLO. REV. STAT. ANN. § 7-80-401(1); ILL. COMP. STAT. ch. 805, § 180/15-1; KAN. STAT. ANN. § 17-7612; TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 2.12.

152. Rev. Rul. 93-6, 1993-3 I.R.B. 8.

153. COLO. REV. STAT. ANN. § 7-80-401(1). That section provides:

Except as provided in this article, management of the limited liability company's business and affairs shall be vested in a manager or managers. The articles of organization or the operating agreement of the limited liability company may apportion management responsibility or voting power among the

conclusion:

Under the [Colorado] Act, the management of a limited liability company is vested in managers elected by the company's members. The elected managers may or may not be members of the company, and may or may not include all members of the company. Members, by sole virtue of being members, do not possess managerial authority. Although all of M's members are elected managers of M, M nevertheless possesses centralized management, because, as provided by the Act, authority to make management decisions rests solely with the five members in their capacity as managers rather than as members.<sup>154</sup>

This revenue ruling is particularly noteworthy for two reasons. First, any LLC organized under the Colorado Act will always have both limited liability *and* centralized management.<sup>155</sup> Because Colorado LLCs inherently possess two corporate characteristics, limited liability and centralized management, Colorado LLCs have less flexibility in the areas of transferability of interests and continuity of life.<sup>156</sup> These inherent corporate characteristics make Colorado LLCs less attractive than LLCs organized under the laws of other states.<sup>157</sup>

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several managers, if there are two or more, in any manner or upon any basis not inconsistent with this article.

COLO. REV. STAT. ANN. § 7-80-401(1).

154. Rev. Rul. 93-6, 1993-3 I.R.B. at 10.

155. The IRS gave particular attention to the fact that no restriction was placed on who could be a manager and how the members derived their management authority, noting that "[t]he elected managers may or may not be members of the company, and may or may not include all members of the company. Members, by sole virtue of being members, do not possess managerial authority." Rev. Rul. 93-6, 1993-3 I.R.B. at 10. Accordingly, a Colorado LLC could arguably still avoid centralized management by stipulating in the articles of organization or operating agreement that all members must be designated managers of the LLC and that non-member managers are prohibited. This requirement would bestow managerial authority in the members solely by virtue of their membership rather than simply by virtue of their managerial status.

156. Because an entity will be classified as a corporation for federal income tax purposes if it possesses more corporate than non-corporate characteristics, Treas. Reg. § 301.7701-2(a)(3) (1980), should the IRS find that a Colorado LLC possesses *either* transferability or continuity, the LLC will be characterized as a corporation, and the members will lose the pass-through tax advantage of partnership characterization. *See supra* text accompanying notes 7-12.

157. Contrast Colorado's statute with the second generation of LLC statutes that borrowed from the Colorado provision. These statutes vest management power in managers but allow for the articles of organization or operating agreement to provide for management by the members. *Compare* COLO. REV. STAT. ANN. § 7-80-401(1) *with* TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 2.12. The Texas statute provides in pertinent part:

*Except and to the extent the [operating agreement] shall reserve the same to the members in whole or in part, the powers of a limited liability company shall be exercised by or under the authority of, and the business and affairs of a*

Therefore, a change in the Colorado statute is likely.<sup>158</sup>

Second, the revenue ruling suggests that *any* LLC that designates management solely by elected managers will possess centralized management, even if the managers that are eventually elected are all members.<sup>159</sup> Even if all of the managers of an LLC were also members, they would still derive their authority to make management decisions from their capacity as managers rather than members. Because the members would not possess managerial authority "by sole virtue of being members,"<sup>160</sup> under Revenue Ruling 93-6, the grant of managerial power to members by electing them as managers would create the corporate characteristic of centralized management for the purposes of assessing the company's federal income tax characterization.

For example, suppose that an Illinois LLC with five members, in accordance with ILLCA section 15-1, stipulated in its articles of organization that the LLC will be managed by five managers elected annually by the members. Further suppose that the articles do not restrict who can be elected as a manager. In each year of the LLC's existence, the five members elect themselves as managers, and no other managers ever exist. Revenue Ruling 93-6 suggests that the LLC possesses centralized management because the members derive their managerial authority by virtue of their role as elected managers, not by virtue of being members.

Of course, since Illinois vests management power in LLC *members* rather than managers, this situation should not arise in an Illinois LLC. If the members of an Illinois LLC intend to be the sole managers of the LLC throughout its existence, they should include a provision in the LLC's operating agreement that expressly vests managerial authority in all the members solely by virtue of their status as members. Such a provision would not alter the default provision of the Illinois statute,

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limited liability company shall be managed under the direction of, the managers of the limited liability company.

TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 2.12 (emphasis added). The introductory clause of the Texas provision saves Texas LLCs from the adverse consequences arising from Revenue Ruling 93-6. This clause allows Texas LLCs that intend to be managed by the members simply to include a provision vesting management authority in the members. Thus, Texas LLCs can easily avoid the *per se* centralized management rule that now applies to Colorado LLCs.

158. Colorado could, for example, amend its management provision by adding an introductory clause that is similar to the Texas statute. See, e.g., TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 2.12.

159. See Rev. Rul. 93-6, 1993-3 I.R.B. at 10 ("Although all of M's members are elected managers of M, M nevertheless possesses centralized management . . .").

160. *Id.* at 10.

but would clarify for the purposes of characterizing the LLC under the Internal Revenue Code that the members are to have managerial authority.

Nevertheless, Revenue Ruling 93-6 does appear to have potential application to Illinois LLCs in limited circumstances. For example, five member-managers of an Illinois LLC might bring in a non-member as a sixth manager who, although lacking the capital necessary to become a member, has particular expertise in the LLC's line of business. In such a situation, the sixth manager would derive her managerial authority by virtue of being an elected manager rather than from her status as a member.<sup>161</sup> Similarly, the five member-managers would apparently derive their authority to make management decisions from their capacity as managers rather than members.<sup>162</sup> Under Revenue Ruling 93-6, centralized management would appear to exist.<sup>163</sup>

Other state law issues, unrelated to federal income tax classification, are particularly helpful in determining the most beneficial managerial structure of an LLC and the type of provisions that must be included in the articles of organization or operating agreement. Generally, managers need not be members of the LLC or residents of the state of organization. Illinois and some other states do not impose any obligations on managers, but merely provide that the articles of organization or operating agreement will govern the rights and duties of managers.<sup>164</sup> In contrast, those states that vest management powers in managers by default generally establish detailed provisions governing issues such as manager vacancies, removal of managers, meeting and quorum requirements, and standards of conduct.<sup>165</sup> On the other hand, the Illinois-type statutes that vest initial management power in the members typically provide that the operating agreement or articles of organization exclusively govern managerial structure and procedure.<sup>166</sup> Illinois, and many other states generally allow an LLC to indemnify members or managers for any legal action taken against

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161. See Rev. Rul. 93-6, 1993-3 I.R.B. 8.

162. See *id.*

163. The converse of this example also raises questions. Assume that an Illinois LLC has five members, four of whom have some capital and a great deal of business experience, while the fifth member has a great deal of capital but no business experience. If the fifth member has no managerial authority, then the four managing members would seem to derive their authority by virtue of being managers, not members.

164. See, e.g., ILL. COMP. STAT. ch. 805, § 180/15-1.

165. See, e.g., COLO. REV. STAT. ANN. §§ 7-80-403 to -406; TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 2.12 to .21; VA. CODE ANN. §§ 13.1-1024 to -1024.1.

166. See, e.g., ILL. COMP. STAT. ch. 805, § 180/15-1.

them in their representative capacity to the extent they were acting on behalf of the LLC.<sup>167</sup>

States are split as to whether members must elect managers annually. Moreover, the split does not follow according to whether management powers are vested in the members or in managers. For example, of the states that vest management power in members by the use of a default provision, Florida, Nevada, and Wyoming require annual election of managers if the articles provide for management by managers, whereas Illinois and Kansas do not require any specific terms or election periods for managers.<sup>168</sup> Of the states that vest management power in managers by default, Colorado and Texas take a different approach and expressly allow staggered terms by permitting the LLC to divide the managers into two or three classes.<sup>169</sup> In Illinois and other states which permit the election of managers to be prescribed by the articles of organization or operating agreement, managers apparently can be elected to staggered terms and can be elected for any reasonable length of term if provided for in the operating agreement or articles of organization.<sup>170</sup>

## 2. Authority of Members in Member-Managed Companies

Similar to many other statutes, the ILLCA stipulates that voting power of members is allocated according to the proportional value of each member's contributions.<sup>171</sup> The articles of organization or operating agreement, however, may alter the voting power.<sup>172</sup> Thus, provisions creating super-majority voting requirements,<sup>173</sup> cumulative voting-type arrangements,<sup>174</sup> or other allocations of voting power are

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167. See, e.g., ILL. COMP. STAT. ch. 805, § 180/15-10; COLO. REV. STAT. ANN. § 7-80-410; UTAH CODE ANN. § 48-2b-155 (1992).

168. Compare NEV. REV. STAT. ANN. § 86.291 (Michie Supp. 1991); WYO. STAT. § 17-15-116; FLA. STAT. ANN. § 608.422 with ILL. COMP. STAT. ch. 805, § 180/15-1; KAN. STAT. ANN. § 17-7612.

169. See COLO. REV. STAT. ANN. § 7-80-403; TEX. REV. CIV. STAT. ANN. Art. 1528n, arts. 2.13, 4.02.

170. See, e.g., ILL. COMP. STAT. ch. 805, § 180/15-1.

171. ILL. COMP. STAT. ch. 805, § 180/10-5; see also VA. CODE ANN. § 13.1-1022(B).

172. See, e.g., ILL. COMP. STAT. ch. 805, § 180/10-5; VA. CODE ANN. § 13.1-1022(B). But see KAN. STAT. ANN. § 17-7612 (vesting authority in members equally unless the articles otherwise provide).

173. A super-majority voting requirement is any provision requiring the affirmative vote of more than a mere majority; for example, a provision requiring a two-thirds, three-quarters, or unanimous vote.

174. Cumulative voting is a device used in corporations to assure that minority shareholders are represented on a corporation's board of directors. Under cumulative voting, each shareholder multiplies the number of shares that he owns by the number of directors to be elected. This calculation determines the number of aggregate votes that

allowed.

The ILLCA provides that if members manage the LLC, the members have the authority to bind the LLC through individual action taken on behalf of the organization unless the articles of organization or operating agreement restrict this authority.<sup>175</sup> In this respect, the ILLCA resembles a general partnership statute.<sup>176</sup> Because a member does not have the authority to bind an LLC managed by an elected manager unless that power is specifically reserved to members in the articles of organization or operating agreement,<sup>177</sup> creditors of Illinois LLCs must use caution in determining whether a debtor-LLC is managed by its members or rather by managers to determine whether the members have the authority to bind the company.

A significant question also arises regarding the application of the corporate business judgment rule<sup>178</sup> to management decisions by members in member-managed organizations. Although courts describe the rule as applying to decisions by corporate directors,<sup>179</sup> there is no reason that the same rule should not apply to LLC member-managers who occupy a management role directly analogous to corporate directors. ILLCA section 180/10-10 seems to sanction the application of the business judgment rule to LLCs. The theory that section

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the shareholder may cast. *See* ILL. COMP. STAT. ch. 805, § 5/7.40(a); HARRY G. HENN & JOHN R. ALEXANDER, *LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 189 at 495, § 266 at 719 (3d ed. 1983). The shareholder may then cast his votes in any way he chooses, giving all his votes to one candidate ("cumulating" his votes) or spreading them among several candidates. HENN & ALEXANDER, *supra* § 189 at 495. In the absence of cumulative voting, a shareholder or group of shareholders that controls greater than fifty percent of the shares entitled to vote can elect the *entire* board of directors. Cumulative voting thus makes it easier for minority shareholders to obtain representation on the board of directors.

Note that since LLC members' interests are not issued in "shares" as voting power is in a corporation, it would be necessary to structure cumulative voting-type arrangements differently than in a corporation. Thus, although they would not be true cumulative voting arrangements, they could have the same effect.

175. *See, e.g.*, ILL. COMP. STAT. ch. 805, § 180/15-1.

176. *See* ILL. COMP. STAT. ch. 805, § 205/9.

177. *See* ILL. COMP. STAT. ch. 805, § 180/15-1.

178. Generally, the business judgment rule holds that corporate directors are not liable for a faulty business decision if the decision was made by a disinterested director who was reasonably informed with respect to the subject of the decision and the director rationally believed that the decision was in the best interest of the company. *See* HENN & ALEXANDER, *supra* note 174, § 242 at 661; *Powell v. Western Ill. Elec. Coop.*, 536 N.E.2d 231, 233 (Ill. App. Ct. 1989); *Lower v. Lanmark Mut. Fire Ins. Co.*, 448 N.E.2d 940, 944-45 (Ill. App. Ct. 1983); *Romanik v. Lurie Home Supply Center, Inc.*, 435 N.E.2d 712, 718, 722 (Ill. App. Ct. 1982); *Shlensky v. Wrigley*, 237 N.E.2d 776, 778-81 (Ill. App. Ct. 1968). The leading case outside of Illinois is *Smith v. Van Gorkum*, 488 A.2d 858, 872-73 (Del. 1985).

179. *See, e.g., Lower*, 448 N.E.2d at 944.

180/10-10 incorporates the rule is drawn directly from the text of the statute, which provides that "[a] manager of a limited liability company shall be personally liable for any act . . . to the extent that a director of an Illinois business corporation is liable in analogous circumstances under Illinois law."<sup>180</sup> While only future case law will conclusively determine whether section 180/10-10 incorporates the business judgment rule, an earlier version of the proposed ILLCA explicitly applied the rule to LLC managers and therefore suggested that the Illinois legislature intended to incorporate the rule.<sup>181</sup>

### 3. Authority of Managers in Companies Managed by Non-Members

As a result of the divergent stances that states have taken as to whether management power initially vests in members or in managers,<sup>182</sup> the various state statutes grant a different scope of authority to non-member managers. Generally, those state statutes that contain a default provision initially vesting management power in non-member managers explicitly specify the duties and requirements of managers, in a manner similar to state statutes regulating corporations.<sup>183</sup> In contrast, the states that vest management power in the members by default leave this task to the operating agreement or articles of organization.<sup>184</sup> This observation, however, does not hold true in all situations.

The ILLCA, which contains a default provision initially vesting management power in the LLC's members, allows maximum flexibility by providing that managers have the "authority and responsibility accorded to them by the operating agreement or articles of organization."<sup>185</sup> Other states are not as flexible in this regard. The

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180. ILL. COMP. STAT. ch. 805, § 180/10-10(b).

181. See S. 1429, 87th Gen. Assembly, § 15-20 (Ill. 1991). When the Illinois act was first introduced, § 180/10-10, which pertains to member and manager liability, provided that "[m]embers and managers of limited liability companies shall not be liable in any manner for any debt, obligation, or liability of the limited liability company or each other." S. 1429, 87th Gen. Assembly, § 15-20 (Ill. 1991). Proposed § 180/10-10 was complemented by the explicit business judgment rule provision. This provision was apparently deleted when § 180/10-10 was altered to its current form, which seems to encompass the business judgment rule.

182. See *supra* text accompanying notes 148-50.

183. See *supra* note 157.

184. See *supra* note 157.

185. ILL. COMP. STAT. ch. 805, § 180/15-1. There is some question as to the scope of a manager's authority where neither the articles of organization nor the operating agreement expressly delineates that authority. Although it would seem that general agency principles should govern, because neither the courts nor the legislature has addressed this issue, practitioners must proceed with caution where members wish to limit the scope of managerial authority. See RIBSTEIN & KEATINGE, *supra* note 1,



Colorado Act, which, in contrast to Illinois, vests initial management power in designated non-member managers, expressly sets forth the ability of managers to contract for debts and acquire and dispose of property, and explicitly establishes the standard of manager conduct and other general duties of a manager.<sup>186</sup> Kansas, Florida, and Wyoming, which, like Illinois, vest initial management power in the members,<sup>187</sup> fall somewhere between Illinois and Colorado.<sup>188</sup> Thus, in Illinois and most other states, managers possess and therefore can exercise authority only to the extent that it has been accorded to them in the operating agreement, articles of organization, or the statute, whereas members have the unqualified authority to make all decisions regarding LLC business and procedural matters.

As discussed above,<sup>189</sup> the application of the business judgment rule to decisions made by an LLC manager is a significant but unanswered question in most states. The ILLCA appears to have incorporated the business judgment rule, and there appears to be no valid reason to distinguish between its application to member-managed companies and companies managed by non-member managers.<sup>190</sup> In other states, a common-law version of the business judgment rule will probably develop in the area of LLC law in much the same manner as it has developed in the corporate context.

#### IV. COMPARISON WITH OTHER BUSINESS ENTITIES IN ILLINOIS

This section compares the most significant provisions of the Illinois Limited Liability Company Act,<sup>191</sup> the Illinois Business Corporation Act of 1983,<sup>192</sup> the Illinois Uniform Partnership Act,<sup>193</sup> and the Illinois Revised Uniform Limited Partnership Act.<sup>194</sup> Provisions of statutes

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Appendix A—Operating Agreement. It is imperative to note that the management provisions in the Ribstein and Keatinge sample operating agreement could cause the LLC to possess centralized management. See Rev. Rul. 93-6, 1993-3 I.R.B. 8, discussed *supra* notes 152-55 and accompanying text.

186. COLO. REV. STAT. ANN. §§ 7-80-406 to 408.

187. See *supra* note 148 and accompanying text.

188. These statutes generally provide that managers have the ability to contract debts, but do not contain provisions regarding other rights and duties of managers or establish a specific standard of manager conduct. See FLA. STAT. ANN. §§ 608.424 to .425; KAN. STAT. ANN. § 17-7614; WYO. STAT. §§ 17-15-117 to -118.

189. See *supra* notes 178-81 and accompanying text.

190. See *supra* notes 178-81 and accompanying text.

191. ILL. COMP. STAT. ch. 805, §§ 180/1-1 to 60-1 (West Supp. 1993) (effective January 1, 1994) ("ILLCA").

192. ILL. COMP. STAT. ch. 805, §§ 5/1.01-17.05 (West 1992) ("IBCA").

193. ILL. COMP. STAT. ch. 805, §§ 205/1-43 (West 1992) ("IPA").

194. ILL. COMP. STAT. ch. 805, §§ 210/100-1205 (West 1992) ("ILPA").

from other jurisdictions are discussed where pertinent.<sup>195</sup>

### A. Formation and General Provisions

Similar to corporations and limited partnerships, a limited liability company is formed by filing articles of organization with the Secretary of State.<sup>196</sup> In this sense, LLCs differ from general partnerships, which do not require any similar filing and instead are simply created by statute where two or more people carry on a business for profit as co-owners.<sup>197</sup> An LLC's articles of organization must contain certain information specified in the statute which generally parallels the information that the IBCA and the ILPA require.<sup>198</sup> The ILLCA differs slightly from the IBCA and ILPA in that the articles of organization need not contain any information regarding capitalization.<sup>199</sup>

As with corporations, the members of an LLC may adopt an "operating agreement," which is similar to corporate by-laws.<sup>200</sup> Although not expressly addressed in either the IPA or the ILPA, partners in a partnership may utilize a partnership agreement in a manner similar to an LLC operating agreement or corporate by-laws.<sup>201</sup> Because LLCs are generally treated as partnerships for tax purposes,<sup>202</sup> LLC operating agreements should generally be drafted in a

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195. For a discussion of the issues that arise in choosing a business entity see Kalinka, *supra* note 1, at 1109-23. That article provides a hypothetical fact pattern involving a closely-held business and discusses the advantages and disadvantages of organizing the business as a corporation (under both subchapter C and S of the Internal Revenue Code), a partnership, a limited partnership, and an LLC.

196. Compare ILL. COMP. STAT. ch. 805, §§ 180/5-1 and 5-55 with ILL. COMP. STAT. ch. 805, §§ 5/1.10 and 2.10 (requiring filing of articles of incorporation with the Secretary of State) and ILL. COMP. STAT. ch. 805, § 210/201 (requiring filing of certificate of limited partnership with the Secretary of State).

197. See ILL. COMP. STAT. ch. 805, § 205/6(1); see also ILL. COMP. STAT. ch. 805, § 205/7 (setting forth criteria to be considered in determining whether a partnership exists).

198. Compare ILL. COMP. STAT. ch. 805, § 180/5-5 with ILL. COMP. STAT. ch. 805, § 5/2.10 and ILL. COMP. STAT. ch. 805, § 210/201.

199. Compare ILL. COMP. STAT. ch. 805, § 180/5-5 with ILL. COMP. STAT. ch. 805, § 5/2.10(a)(5)-(8) (requiring that the articles of incorporation provide certain information including the number of, characteristics of, and consideration to be paid for shares of stock) and ILL. COMP. STAT. ch. 805, § 210/201(5)-(6) (requiring that the certificate of limited partnership provide information regarding the amount of cash and the value of other property or services that the partners contribute and a statement of the partners' membership and distribution rights).

200. Compare ILL. COMP. STAT. ch. 805, § 180/15-5 with ILL. COMP. STAT. ch. 805, § 5/2.25.

201. See ILL. COMP. STAT. ch. 805, § 205/18 (specifying the rights and duties of partners "subject to any agreement between them").

202. See *supra* part III.

manner similar to partnership agreements.<sup>203</sup>

Similar to corporations, one or more persons may organize a limited liability company.<sup>204</sup> However, LLCs must have at least two members, whereas a single shareholder may own all the stock in a corporation.<sup>205</sup> Illinois LLCs, like corporations and limited partnerships, may generally be organized for any legal purpose except banking or insurance.<sup>206</sup> The respective Illinois statutes also permit both LLCs and corporations to exercise similar powers such as the right to sue and be sued, invest funds, purchase, sell and mortgage realty or personalty, lend and borrow money, become owners of a partnership, another LLC, joint venture or other enterprise, and conduct their business.<sup>207</sup>

Unlike the ILLCA, the Illinois corporate statute provides that persons who exercise corporate powers without authority to do so are jointly and severally liable for all debts and liabilities resulting from such action.<sup>208</sup> This provision arguably precludes de facto corporate status in Illinois.<sup>209</sup> It is unclear whether this provision extends to

203. See Keatinge, *supra* note 1, at 85; RIBSTEIN & KEATINGE, *supra* note 1, Appendix A—Operating Agreement. In contrast to standard corporate by-laws, LLC operating agreements should contain provisions such as partnership-type tax allocations that address the requirements and tax consequences associated with subchapter K tax treatment. Keatinge, *supra* note 1, at 84-86. For example, LLCs taxed under subchapter K must maintain capital accounts, which essentially represent each member's share of the LLC. See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(1) (as amended in 1987). For a discussion of these issues, see Keatinge, *supra* note 1, at 84-86; Gazor & Goff, *supra* note 1, at 452-53.

204. Compare ILL. COMP. STAT. ch. 805, § 180/5-1(a) with ILL. COMP. STAT. ch. 805, § 5/2.05(a).

205. Compare ILL. COMP. STAT. ch. 805, § 180/5-1(b) with ILL. COMP. STAT. ch. 805, § 5/2.05(a). But see TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 3.01 (West Supp. 1993). Unlike the ILLCA, Texas requires that an LLC must have at least one organizer at formation but does not require that an LLC have more than one member. See TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 3.01.

206. See ILL. COMP. STAT. ch. 805, § 180/1-25; ILL. COMP. STAT. ch. 805, § 5/3.05; ILL. COMP. STAT. ch. 805, § 210/105 (additionally prohibiting limited partnerships from operating railroads).

207. See ILL. COMP. STAT. ch. 805, § 180/1-30; ILL. COMP. STAT. ch. 805, § 5/3.10.

208. See ILL. COMP. STAT. ch. 805, § 5/3.20; see also ILL. COMP. STAT. ch. 805, § 5/2.15 (providing that the issuance of a certificate of incorporation is conclusive evidence of proper incorporation).

209. At common law, the de facto corporation doctrine was used by "shareholders" to avoid liability when the corporation had not been properly formed. Under the de facto corporation doctrine, if the incorporators made a good faith attempt to meet the requirements of incorporation, courts would often hold that the organization was a "de facto" corporation. See, e.g., *Timberline Equip. Co. v. Davenport*, 514 P.2d 1109, 1110 (Or. 1973). For an Illinois case discussing the de facto corporation doctrine, see *Davane Inc. v. Mongreig*, 550 N.E.2d 55, 58 (Ill. App. Ct. 1990). Thus, although the organization was not technically a corporation, courts treated the owners as shareholders who were

Illinois LLCs through ILLCA section 180/10-10, which imposes personal liability on members and managers to the extent that a corporate shareholder or director would be liable in similar circumstances under the IBCA.<sup>210</sup> The ILPA, upon which much of the ILLCA was modeled,<sup>211</sup> does not contain a provision imposing joint and several liability, such as IBCA section 5/3.20. Unlike LLC members, however, general partners in a limited partnership are always personally liable for the partnership's debts and liabilities.<sup>212</sup> In contrast, LLC members, like corporate shareholders, are protected by the veil of limited liability.<sup>213</sup> In light of ILLCA section 180/10-10, which holds LLC members and managers liable to the extent that shareholders and directors are liable under Illinois' law governing corporations, LLC members will likely be held jointly and severally liable for acting without proper formation. In effect, the LLC members would be treated as partners in a general partnership just as persons acting without proper formation are treated in the corporate context.<sup>214</sup>

### *B. Capital Structure and Capital Contributions*

One of the more advantageous features of structuring an entity as a limited liability company rather than a corporation is the increased flexibility that the ILLCA permits in capital structure. In contrast to corporate ownership, limited liability company ownership interests are not issued as shares or certificates.<sup>215</sup> Thus, whereas corporations

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not personally liable for the liabilities of the de facto corporation. Courts have generally viewed statutory provisions similar to IBCA § 5/3.20, which hold personally liable all persons purporting to act on behalf of a corporation that was defectively formed, as having supplanted the de facto corporation doctrine. *See, e.g., Timberline*, 514 P.2d at 1111. Although some have argued that IBCA § 5/3.20 abolishes the de facto corporation doctrine, the recent application of the doctrine in an Illinois case makes it uncertain whether the IBCA has supplanted this doctrine in Illinois. *See Department of Revenue v. Roman S. Dombrowski Enter., Inc.*, 560 N.E.2d 881, 885 (Ill. App. Ct. 1990).

210. *See supra* text accompanying note 91.

211. Compare ILL. COMP. STAT. ch. 805, §§ 180/20-10 to -15, 180/25-1 to -20, 180/40-1 to -15 with ILL. COMP. STAT. ch. 805, §§ 210/503-04, 210/601-06, 210/1001-04.

212. *See* ILL. COMP. STAT. ch. 805, § 210/403.

213. *See* ILL. COMP. STAT. ch. 805, § 180/10-10(a); ILL. COMP. STAT. ch. 805, § 5/6.40.

214. This result would also be expected under ILL. COMP. STAT. ch. 805, § 205/6(1), which provides that a partnership exists where two or more persons act as co-owners of a business for profit.

215. This characteristic raises the question of whether the securities laws apply to LLC ownership interests. Generally, it appears that securities laws do not apply to member-managed companies but do apply to LLCs managed by non-members. *See Securities and Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). In any

may only issue shares of stock according to the number, classes, and terms specified in the articles of incorporation,<sup>216</sup> LLCs are not bound by such limitations. The flexible capital structure permitted by the ILLCA further provides an attractive option to the rigid limitations placed on the capital structure of S corporations.<sup>217</sup> Subchapter S corporations are limited to one class of stock and a maximum of thirty-five shareholders, and may not have nonresident aliens, corporations, partnerships, pension funds, charitable organizations, or certain trusts as stockholders.<sup>218</sup> Because LLCs are not bound by any of these restraints, members of an LLC possess far greater versatility in designing the capital structure of an LLC than do shareholders of an S corporation.

Moreover, LLC member contributions may be in the form of cash, property, services rendered, a promissory note or other obligation to contribute cash or property or to perform services.<sup>219</sup> This provision offers slightly greater flexibility than its counterpart in the IBCA, which permits only money, property, or labor or services actually performed to be given as consideration for shares of stock.<sup>220</sup> Under the ILLCA, however, a promise by a member to contribute cash, property, or services is enforceable only if made in writing and signed by the member.<sup>221</sup> Upon such a promise, the member becomes liable to the LLC to perform the promised obligation, and a member who becomes unable to contribute the promised property or services must contribute cash of equal value.<sup>222</sup>

Although these ILLCA provisions are analogous to the limited part-

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case, most "offerings" by LLCs—that is, the offering of ownership interests in the LLC to prospective members—would probably be exempt from registration under the federal Securities Act of 1933. See, e.g., 15 U.S.C.A. § 77d(2) (West 1981) (allowing an exemption from registration for private offerings). For a more complete discussion of the application of securities laws to limited liability companies see Keatinge, *supra* note 1, and text accompanying notes 192-98.

216. See ILL. COMP. STAT. ch. 805, § 5/6.05.

217. See *supra* note 4 and accompanying text.

218. See I.R.C. § 1361 (Supp. V 1993).

219. ILL. COMP. STAT. ch. 805, § 180/20-1. This provision is virtually identical to the analogous provision in the limited partnership statute. See ILL. COMP. STAT. ch. 805, § 210/501.

220. See ILL. COMP. STAT. ch. 805, § 5/6.30. But see REVISED MODEL BUSINESS CORP. ACT § 6.21(b) (1985) (permitting corporations to authorize the issuance of shares in exchange for, *inter alia*, promissory notes and contracts to perform future services). Note that any services performed in exchange for shares in a corporation must be performed *for the corporation*. Thus, *pre-incorporation* services might not be sufficient consideration for shares in an Illinois corporation.

221. See ILL. COMP. STAT. ch. 805, § 180/20-5(a).

222. See ILL. COMP. STAT. ch. 805, § 180/20-5(b).

nership statute in many ways,<sup>223</sup> they differ from the ILPA provision on liability for contributions in one profound respect. Under ILPA section 502(c), a creditor of a limited partnership may directly enforce a partner's obligation to make a contribution if the creditor acted in reliance on the partner's promise to make the contribution.<sup>224</sup> The conspicuous absence of such a provision from the LLC statute suggests that an LLC member's liability for contributions is not the same as that of a partner in a limited partnership. Instead, an LLC member's liability for contribution is analogous to a corporate shareholder's liability solely to the corporation.<sup>225</sup>

### C. Management Structure

One of the benefits of LLCs is that the flexible nature of most statutes allows the management structure of an LLC to range from a detailed corporate-like scheme (managed entirely by non-members) to a general partnership-type design (fully member-managed with amended voting powers).<sup>226</sup> The default provision in the ILLCA establishes a variation of the general partnership structure by vesting management powers in the members but allocating voting power according to the book value of each member's interest.<sup>227</sup> The ILLCA also provides that members of member-managed firms have the same power to bind the LLC in transactions with third parties as do partners in a general partnership.<sup>228</sup> Thus, Illinois LLCs differ from general partnerships as to the allocation of voting power, but, similar to general partnerships, have the characteristic that members of member-managed LLCs can bind the LLC through individual action.

In addition, the structure of management authority in limited liability

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223. Compare ILL. COMP. STAT. ch. 805, § 180/20-5 with ILL. COMP. STAT. ch. 805, §§ 210/501 and 502.

224. See ILL. COMP. STAT. ch. 805, § 210/502(c).

225. Compare ILL. COMP. STAT. ch. 805, § 180/20-5 with ILL. COMP. STAT. ch. 805, § 5/6.40 ("A holder of or subscriber to shares of a corporation shall be under no obligation to the corporation or its creditors with respect to such shares other than the obligation to pay to the corporation the full consideration for which the shares were issued or to be issued." (emphasis added)).

226. See *supra* part III.D.1 for a discussion of the type of management structure permitted by various state LLC statutes.

227. Compare ILL. COMP. STAT. ch. 805, §§ 180/10-5 and 15-1 with ILL. COMP. STAT. ch. 805, § 205/18(e) (providing that subject to any agreement to the contrary, all partners have equal rights in management). See *supra* part III.D.1 for a more thorough discussion of the Illinois default provision.

228. Compare ILL. COMP. STAT. ch. 805, § 180/15-1 with ILL. COMP. STAT. ch. 805, § 205/9(1). The articles of organization may, however, circumscribe the members' authority to bind the LLC. See ILL. COMP. STAT. ch. 805, § 180/15-1.

companies differs significantly from limited partnerships. A limited partnership is managed only by the general partners.<sup>229</sup> In contrast, all LLC members have the right to manage the company, and even if managers are elected, LLC members may retain for themselves any authority otherwise given to managers.<sup>230</sup> Therefore, LLC members will generally have greater management authority and control over the management of the company than limited partners, regardless of whether the LLC is member-managed or managed by non-members. Limited partners are further subject to the "control rule." Under this rule, a limited partner can be held liable as a general partner if that partner participates in the control of the business.<sup>231</sup> Even in an LLC where the managers are not members of the company, the LLC members will most likely be able to remove a manager or elect a new manager for the next term of office as is the case with corporate boards of directors.<sup>232</sup> General partners in a limited partnership are sometimes not as easy to remove because they are, by definition, owners of the business.

Although the ILLCA contains a default provision vesting initial management power in LLC members, an LLC can depart from this default management structure and instead establish a corporate-style management structure by providing for management by non-member managers.<sup>233</sup> In contrast, the IBCA vests all management powers in the board of directors.<sup>234</sup> Since LLC management power is not initially vested in managers, managers, unlike corporate directors, have only the authority and responsibility allocated to them by the arti-

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229. This is a consequence of the "control rule" contained in ILL. COMP. STAT. ch. 805, § 210/303, and discussed *infra* text accompanying note 231.

230. ILL. COMP. STAT. ch. 805, § 180/15-1.

231. ILL. COMP. STAT. ch. 805, § 210/303.

232. Although the ILLCA does not provide for annual elections of managers, it is likely that an LLC that is managed by non-member managers will provide in its articles or organizing agreement for regular manager elections and removal provisions that resemble the scheme established in the corporate context. *See* ILL. COMP. STAT. ch. 805, §§ 5/8.10(c) and 8.35.

233. ILL. COMP. STAT. ch. 805, § 180/15-1. Care must be taken in establishing such a scheme because such a provision can be embodied only in the articles of organization, not the operating agreement. *Id.*

234. *See* ILL. COMP. STAT. ch. 805, § 5/8.05. The IBCA permits two exceptions. First, a close corporation may provide in its articles of incorporation that the corporation is to be managed by the shareholders rather than the board of directors. *See* ILL. COMP. STAT. ch. 805, §§ 5/2A.45, 8.05(a). Second, the articles of incorporation or by-laws of a corporation may provide that the shareholders, rather than the board of directors, will have the authority to establish the directors' salaries. *See* ILL. COMP. STAT. ch. 805, § 5/8.05(c).

cles of organization or operating agreement.<sup>235</sup> This provision allows LLC members to establish their own agreements regarding the specific governing provisions, such as election procedures, term limits, voting guidelines, and related provisions.<sup>236</sup> The practical effect is to allow LLC members to grant managers the same management powers as are exercised by a corporation's board of directors, thus establishing a management structure virtually the same as that which exists in a corporation.

One adverse consequence of structuring an LLC's management to resemble a corporation is that the LLC will increasingly jeopardize its partnership tax status the closer it comes to employing a corporate-style management scheme.<sup>237</sup> Moreover, since the typical LLC is likely to restrict members from transferring their ownership interests, LLC members may desire a greater role in management to protect their own interests in the company. In the final analysis, the members' practical business concerns and the consequences of tax classification will determine the specific type of management design in an LLC.

#### *D. Fiduciary Duties*

Very much related to the management of limited liability companies is the issue of the type of fiduciary duties that LLC members and managers owe to the company and to each other. As in Illinois, most LLC statutes have failed to address this issue. In addition, those states that have enacted provisions regarding the fiduciary duties of members and managers merely provide that managers are to act in good faith and in the best interests of the LLC.<sup>238</sup>

ILLCA section 180/10-10 provides that liability for members and managers will be the same as in the corporate context. Because most LLCs will likely be closely-held, however, such a provision may not be effective in solving the specific problems which may arise in the typical LLC environment. For example, a corporate transaction in which a director has a conflict of interest is valid if approved by a majority of disinterested shareholders or directors after full disclosure of the conflict.<sup>239</sup> The closely-held character, which will presumably become typical of LLCs, indicates that truly disinterested members or managers will rarely exist. Therefore, commentators have suggested

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235. See ILL. COMP. STAT. ch. 805, § 180/15-1.

236. *Id.*

237. See *supra* part III.D.

238. See, e.g., COLO. REV. STAT. ANN. § 7-80-406(1) (West Supp. 1992); VA. CODE ANN. § 13.1-1024.1.A (Michie 1993).

239. ILL. COMP. STAT. ch. 805, § 5/8.60.



that a rule requiring unanimous consent by all LLC members may be more appropriate.<sup>240</sup>

The Illinois general partnership statute contains an example of the type of unanimous consent provision that LLCs might find useful.<sup>241</sup> The statute provides, for example, that a partner may not benefit from the partnership without the consent of the other partners<sup>242</sup> and that the partners have a duty to fully disclose all information affecting the partnership.<sup>243</sup> These provisions also apply to limited partnerships.<sup>244</sup> LLC members in manager-managed firms, however, do not necessarily need the same protection as limited partners in a limited partnership. Whereas LLC members are likely to have the power to remove non-member managers or at least to elect new managers at the next managerial election, limited partners might not be able to so easily rid themselves of general partners who neglect their fiduciary duties.

The precise treatment of fiduciary duties will probably depend on the type of management structure that an LLC establishes. An LLC with centralized management is likely to invoke the rules set forth in the corporate context, whereas an LLC managed by its members will probably model the rights and duties of members and managers after a general partnership.<sup>245</sup>

### *E. Distributions and Allocation of Profits and Losses*

The ILLCA provisions governing the allocation of profits, losses and distributions mirror the corresponding provisions in the limited partnership act.<sup>246</sup> Those provisions state that distributions and allocations of profits and losses are to be made pursuant to the articles of organization or operating agreement, or, in the absence of such a provision, according to the book value of each member's ownership interest.<sup>247</sup> Accordingly, an LLC may apportion profits, losses, and

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240. See, e.g., Keatinge, *supra* note 1, at 391.

241. See ILL. COMP. STAT. ch. 805, § 205/18-22.

242. *Id.* § 205/21(1).

243. *Id.* § 205/20.

244. See *id.* § 205/6(2) (providing that the provisions of the general partnership act apply to limited partnerships to the extent that they are not inconsistent with the limited partnership act).

245. For an example of such provisions in a generic operating agreement for a member-managed LLC, see RIBSTEIN & KEATINGE, *supra* note 1, Appendix A—Operating Agreement.

246. Compare ILL. COMP. STAT. ch. 805, §§ 180/20-10 and 20-15 with ILL. COMP. STAT. ch. 805, §§ 210/503 and 504.

247. See ILL. COMP. STAT. ch. 805, §§ 180/20-10 and 20-15; ILL. COMP. STAT. ch. 805, §§ 210/503 and 504.

distributions in the manner that is most advantageous to its members. This presents a distinct advantage over S corporations which are generally limited to pro rata allocations of profits and losses.<sup>248</sup> In contrast to the ILLCA's allocation provisions, the counterpart provisions in the IPA state that absent an agreement to the contrary, all partners will share equally in profits, losses, and distributions.<sup>249</sup>

The IBCA distribution provisions are essentially the same as their counterpart provisions in the ILLCA. Like the ILLCA, the IBCA distribution provisions give a corporation's directors the power to authorize distributions,<sup>250</sup> subject to any restriction stated in the articles of incorporation.<sup>251</sup> LLC managers or, in the case of a member-managed LLC, members, have the power to authorize distributions, subject to any limitations in the articles of organization.<sup>252</sup>

Furthermore, corporate directors may not authorize a distribution if the distribution would either render the corporation insolvent or reduce the net assets of the corporation to less than zero or less than the maximum amount payable at the time of distribution to shareholders having preferential rights upon liquidation.<sup>253</sup> The ILLCA contains a similar restriction which states that if the LLC has creditors, no distribution or return of contribution may be made if it would cause the LLC to become insolvent or would reduce the net assets below zero.<sup>254</sup> LLC members or managers who authorize a distribution in contravention to these provisions or the articles of organization are jointly and severally liable to the LLC for the amount of the distribution.<sup>255</sup> The IBCA contains a similar provision.<sup>256</sup>

Finally, unless the operating agreement or articles of organization provide otherwise, an LLC member has the right to receive distribu-

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248. I.R.C. § 1366(a) (Supp. V 1993); *see supra* note 4.

249. ILL. COMP. STAT. ch. 805, § 205/18(a).

250. A "distribution" is a transfer of money or other property from a corporation to or for the benefit of its shareholders in respect of any of its shares. Distributions may be made in the form of, *inter alia*, a dividend or share repurchase. *See* REVISED MODEL BUSINESS CORP. ACT § 1.40(6) (1985).

251. *Compare* ILL. COMP. STAT. ch. 805, § 180/25-25(g) *with* ILL. COMP. STAT. ch. 805, § 5/9.10(a).

252. ILL. COMP. STAT. ch. 805, § 180/25-25(g).

253. *Id.* § 5/9.10(c).

254. ILL. COMP. STAT. ch. 805, § 180/25-25(g). Under both the ILLCA and the IBCA, the term "insolvent" means that the organization is unable to pay its debts as they become due in the usual course of business. *See* ILL. COMP. STAT. ch. 805, § 180/1-5; ILL. COMP. STAT. ch. 805, § 5/1.80(m).

255. ILL. COMP. STAT. ch. 805, § 180/25-25(a).

256. ILL. COMP. STAT. ch. 805, § 5/8.65(a)(1).

tions only in the form of cash.<sup>257</sup> Once the member becomes entitled to a distribution, however, the member steps into the shoes of a creditor of the LLC and is entitled to all creditor remedies.<sup>258</sup> A member becomes entitled to receive a distribution either: (1) as stated in the articles of organization or operating agreement; (2) as decided by the managers; (3) as decided by the members pursuant to a majority vote on the matter; or (4) upon resignation from the LLC.<sup>259</sup> These provisions parallel the analogous provisions in the limited partnership statute.<sup>260</sup>

#### *F. Withdrawal of a Member*

The ILLCA treats the withdrawal of an LLC member similar to the way that the Illinois partnership statutes treat the withdrawal of a partner in limited and general partnerships. A member of an LLC, like a general or limited partner, has the right to resign from the LLC upon giving written notice to the other members.<sup>261</sup> Upon withdrawal, the LLC member is entitled to receive such distributions as designated in the articles of organization or operating agreement, or, in the absence of such a provision, the member is to receive the fair value of his membership interest.<sup>262</sup> Nevertheless, if the withdrawal violates the operating agreement or articles of organization, the resigning member is liable to the LLC for any damages arising from his breach, and the LLC may offset the amount of damages against any distribution due to the member upon resignation.<sup>263</sup>

In contrast to LLCs and limited and general partnerships, corporate shareholders can fully withdraw from their entire ownership interest simply by selling their shares of stock.<sup>264</sup> Accordingly, in the corpo-

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257. ILL. COMP. STAT. ch. 805, § 180/25-15.

258. *Id.* § 180/25-20.

259. *Id.* §§ 180/25-1 and 25-10.

260. *See* ILL. COMP. STAT. ch. 805, §§ 210/601 and 604-06.

261. *Compare* ILL. COMP. STAT. ch. 805, § 180/25-5 with ILL. COMP. STAT. ch. 805, §§ 210/602 and 603. Unlike a general partner, a limited partner must give written notice to each general partner no less than six months prior to withdrawal. *Compare* ILL. COMP. STAT. ch. 805, § 210/602 with ILL. COMP. STAT. ch. 805, § 210/603.

262. *See* ILL. COMP. STAT. ch. 805, § 180/25-10. This provision is similar to the Illinois limited partnership provision governing distributions upon the withdrawal of a partner. *See* ILL. COMP. STAT. ch. 805, § 210/604.

263. *See* ILL. COMP. STAT. ch. 805, § 180/25-5. This provision is similar to the corresponding provisions in the Illinois partnership statutes. *See* ILL. COMP. STAT. ch. 805, § 205/38(2)(a)(II); ILL. COMP. STAT. ch. 805, § 210/602. Partners who withdraw in violation of the partnership agreement also are not entitled to share in the goodwill of the partnership. *See* ILL. COMP. STAT. ch. 805, § 205/38(2)(c)(II).

264. Although close corporations may restrict the transfer of stock, *see* HENN &

rate context, a transfer of stock generally transfers all of the rights that attach to the stock.<sup>265</sup> In contrast, because the free transferability of a *complete* ownership interest in an LLC would jeopardize the LLC's partnership tax characterization,<sup>266</sup> it would not be practical to permit an LLC member to withdraw by simply assigning his complete ownership interest. Therefore, because a bare assignment of an LLC ownership interest will not transfer full ownership rights as it will in a corporation,<sup>267</sup> and an LLC is not likely to permit a member to sell his full interest, it is unlikely that an LLC member will be able to withdraw in the same way that a shareholder can withdraw from a corporation. Nevertheless, an LLC member is always able to withdraw from an LLC quite easily by submitting written notice of resignation.<sup>268</sup>

### G. Dissolution

In Illinois, dissolution and winding up of an LLC occurs upon the happening of any of five events: (i) an event stated in the articles of organization; (ii) unanimous written agreement by the members; (iii) the death, retirement, resignation, bankruptcy, court declaration of incompetence with respect to, or dissolution of a member, or any event that terminates the continued membership of a member; (iv) entry of a decree of judicial dissolution; or (v) administrative dissolution.<sup>269</sup> In accordance with dissolution event (iii), if at least two members remain, the remaining members may unanimously agree to continue the business of the LLC.<sup>270</sup> With the exception of judicial and administrative dissolution, the members may provide alternative dissolution provisions in the articles of organization or operating agreement.<sup>271</sup> For example, Illinois LLCs may provide that upon the occurrence of a

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ALEXANDER, *supra* note 174, § 281 (noting that all such restrictions must be reasonable), such agreements generally only create a right of first refusal or a right to have the corporation repurchase the withdrawing shareholder's stock and thus do not remove the shareholders' right to "withdraw". By definition, however, a close corporation does not have a readily available market for its stock and, therefore, a de facto restriction on withdrawal might exist. Under the Illinois Business Corporation Act, a "frozen-out" shareholder may request a court to authorize a judicial buyout. See ILL. COMP. STAT. ch. 805, §§ 5/12.50(b)(2) and 12.55(a)(3).

265. This proposition is merely a general statement that is not necessarily true in all situations. For example, where a voting trust has been created, the shareholder transfers only the legal title to the trustee, while retaining the beneficial interest. HENN & ALEXANDER, *supra* note 174, §197 at 528.

266. See *supra* part III.C.

267. See ILL. COMP. STAT. ch. 805, § 180/30-10.

268. See *id.* § 180/25-5.

269. *Id.* § 180/35-1.

270. *Id.* § 180/35-1(3).

271. ILL. COMP. STAT. ch. 805, § 180/35-1(1) to (3).

dissolution event, the remaining members may agree to continue the business of the LLC by majority, as opposed to unanimous, consent.<sup>272</sup> The Illinois LLC statute differs from statutes of several other states in that it does not establish a fixed period of duration for LLCs<sup>273</sup> or require that LLCs stipulate a fixed period of duration in their articles of organization.<sup>274</sup>

An LLC may also be dissolved by court order upon a member's application.<sup>275</sup> A court may order dissolution of an LLC when it is no longer reasonably practical to carry on business in accordance with the articles of organization or operating agreement, or when the members or managers in control have acted or intend to act illegally or in a manner that is oppressive or fraudulent and detrimental to the LLC or a petitioning member.<sup>276</sup> The Secretary of State also may dissolve an LLC if the LLC fails to file various reports, pay required fees, or appoint and maintain a registered agent in Illinois.<sup>277</sup> Upon the winding up of a dissolved LLC, the LLC's assets must first be distributed to creditors, including members who are creditors, and then to members.<sup>278</sup> Following the winding up of the company, the LLC must file articles of dissolution with the Secretary of State.<sup>279</sup>

These provisions substantially parallel the limited partnership statute with two exceptions. First, the limited partnership act neither provides for administrative dissolution nor requires a limited partnership to file articles of dissolution with the Secretary of State.<sup>280</sup> Second, the limited partnership statute does not permit partners to alter the statutory dissolution provision to enable the partners to agree to continue the business of the partnership upon dissolution by *less than* unanimous consent.<sup>281</sup> Thus, the limited partnership act mandates that *all* partners consent *in writing* to a continuation of the business, whereas the LLC

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272. See *id.* § 180/35-1(3).

273. Compare ILL. COMP. STAT. ch. 805, § 180/35-1 with COLO. REV. STAT. ANN. § 7-80-204(1)(b) (mandating a 30 year maximum period of duration) and FLA. STAT. ANN. § 608.407(1)(b) (West 1993) (same).

274. Compare ILL. COMP. STAT. ch. 805, § 180/35-1 with KAN. STAT. ANN. § 17-7607(2) (Supp. 1992) and UTAH CODE ANN. § 48-2b-116(1)(b) (Supp. 1992).

275. See ILL. COMP. STAT. ch. 805, § 180/35-5.

276. *Id.* § 180/35-5. Compare ILL. COMP. STAT. ch. 805, § 180/35-5 with ILL. COMP. STAT. ch. 805, § 210/802 (judicial dissolution is proper "whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement").

277. ILL. COMP. STAT. ch. 805, § 180/35-25.

278. *Id.* § 180/35-10(1).

279. *Id.* § 180/35-15 (listing the four provisions that the articles of dissolution must contain); *Id.* § 180/35-20.

280. See ILL. COMP. STAT. ch. 805, § 210/801-804.

281. See *id.* § 210/801(c).

statute dispenses with the writing requirement and merely provides a statutory default provision that permits an LLC to alter the consent requirement in the LLC's articles of organization or operating agreement.<sup>282</sup>

Although the general partnership dissolution provisions also resemble the LLC dissolution rules, some significant distinctions do exist. While remaining LLC members may continue the LLC upon unanimous or majority approval of the remaining members,<sup>283</sup> non-withdrawing partners may continue the partnership over the objection of a withdrawing partner only if that partner caused a dissolution in contravention of the partnership agreement.<sup>284</sup> Moreover, in a partnership, partners may only continue the "business" of the partnership; technically, the partnership dissolves and the "business" is carried on by a new partnership.<sup>285</sup> Finally, due to their limited liability, LLC members are not obligated to contribute to the company's liabilities upon dissolution.<sup>286</sup> In contrast, general partners are liable for such contribution.<sup>287</sup>

Generally, corporate dissolution is comparable to LLC dissolution; however, as with partnerships, notable differences do exist. The shareholders of a corporation may authorize dissolution of a corporation by either (i) unanimous written consent of the holders of outstanding shares who are entitled to vote on dissolution, or (ii) the affirmative vote of two-thirds of the holders of outstanding shares who are entitled to vote on dissolution, following a board resolution or shareholder proposal to dissolve the corporation.<sup>288</sup> Upon voluntary dissolution, a corporation is required to file articles of dissolution similar to those that the ILLCA requires LLCs to file.<sup>289</sup> Unlike an LLC, however, a corporation may file the articles immediately after dissolution has been authorized, and liquidation and winding up may then proceed.<sup>290</sup>

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282. Compare ILL. COMP. STAT. ch. 805, § 210/801(c) with ILL. COMP. STAT. ch. 805, § 180/35-1(3).

283. ILL. COMP. STAT. ch. 805, § 210/801(c).

284. Compare ILL. COMP. STAT. ch. 805, § 180/35-1(3) with ILL. COMP. STAT. ch. 805, § 205/38(2).

285. See ILL. COMP. STAT. ch. 805, § 205/38(2)(b); Keatinge, *supra* note 1, at 402.

286. See Keatinge, *supra* note 1, at 402.

287. ILL. COMP. STAT. ch. 805, § 205/40(d).

288. ILL. COMP. STAT. ch. 805, §§ 5/12.10 and 12.15. In limited circumstances the incorporators or initial directors of a corporation can also dissolve the entity. See ILL. COMP. STAT. ch. 805, § 5/12.05.

289. See ILL. COMP. STAT. ch. 805, § 5/12.20.

290. Compare ILL. COMP. STAT. ch. 805, § 5/12.20(a) with ILL. COMP. STAT. ch. 805, § 180/35-15 (requiring satisfaction of all LLC liabilities and distribution of all LLC as-

Like LLCs, corporations may be subject to administrative and judicial dissolution. The administrative dissolution of a corporation is much like that of an LLC.<sup>291</sup> On the other hand, the judicial dissolution of a corporation differs profoundly from that of an LLC. A shareholder, a creditor, the Illinois Attorney General, or the corporation itself may initiate an action for judicial dissolution of a corporation.<sup>292</sup> The grounds for dissolution in an action by a shareholder are most relevant in the context of judicial dissolution of an LLC. A shareholder may bring an action to dissolve a corporation where there is: (i) director deadlock and irreparable injury to the corporation; (ii) illegal, oppressive, or fraudulent conduct by those in control of a corporation; or (iii) waste of corporate assets.<sup>293</sup>

Although the ILLCA does not have any comparable provisions, the LLC's partnership nature renders such provisions unnecessary. An LLC member's right to resign from the company<sup>294</sup> in effect operates as a right to have the company "buy-out" the member's ownership share in the business and avoid judicial dissolution.<sup>295</sup> Theoretically, the ILLCA could have provided for court-appointed provisional managers or custodians. In practice, however, these remedies are not likely to be effective, particularly where a continuing and deep-rooted conflict exists between business owners, and the statute wisely omits such remedies.

### *H. Derivative Actions*

Illinois treats derivative actions virtually the same in the context of LLCs, limited partnerships, and corporations. In comparison, derivative actions are inapplicable to general partnerships. Some other states expressly provide for derivative actions on behalf of LLCs.<sup>296</sup> Commentators have generally approved this approach, suggesting that rules regarding derivative actions are better set forth by statute than left

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sets to members prior to filing articles of dissolution).

291. Compare ILL. COMP. STAT. ch. 805, §§ 5/12.35, 12.40 and 12.45 with ILL. COMP. STAT. ch. 805, §§ 180/35-25, 35-30 and 35-40.

292. See ILL. COMP. STAT. ch. 805, § 5/12.50.

293. *Id.* § 5/12.50(b). The IBCA also provides alternative remedies to judicial dissolution. Instead of ordering dissolution, a court may appoint a provisional director or custodian, or order the corporation to purchase the complaining shareholder's shares at a fair price. *Id.* § 5/12.55(a).

294. See ILL. COMP. STAT. ch. 805, § 180/25-5; *supra* text accompanying note 261.

295. See ILL. COMP. STAT. ch. 805, §§ 180/25-10 to 25-20. Disputes involving the value of a resigning member's interest might nevertheless arise.

296. Utah and Virginia are among states that do have such provisions. See UTAH CODE ANN. §§ 48-2b-150 to -154 (applicable only to LLCs managed by non-members); VA. CODE ANN. §§ 13.1-1042 to -1045.

to case law.<sup>297</sup>

An LLC member may bring a derivative action on behalf of the LLC only after the members or managers with authority to bring such an action have refused to do so.<sup>298</sup> Nonetheless, a member may bring an action without first having made such a demand if the demand would have been futile.<sup>299</sup> An LLC derivative action may be brought by a person who was a member at the time of the transaction complained of or whose status as a member devolved upon him by operation of law or under the operating agreement from a person who was a member at the time of that transaction.<sup>300</sup> If the derivative action succeeds either in whole or in part, the court may award the plaintiff reasonable expenses, including attorney's fees.<sup>301</sup>

These requirements are identical to the counterpart provisions of the limited partnership statute, with one intriguing exception.<sup>302</sup> The limited partnership provision states that "[n]o action shall be brought by a *limited* partner . . . in the right of a limited partnership to recover a judgment in its favor" unless demand was refused or demand would be futile.<sup>303</sup> The general partnership statute does not contain a provision permitting derivative actions, and therefore, it would be inappropriate to apply such actions to *general* partners in a limited partnership. Thus, the limited partnership act permits only actions "brought by a limited partner."<sup>304</sup> Because LLCs do not have "limited" members, they are more analogous to general partnerships, and, arguably, derivative actions should not be permitted, especially in member-managed LLCs.<sup>305</sup> On the other hand, given the resemblance in ownership and management structure of non-member-managed LLCs to corporations, application of the corporate derivative action rules is not improper.

Although the LLC derivative action provisions are substantively similar to the corporate rules, the LLC provisions differ from the cor-

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297. See Keatinge, *supra* note 1, at 392.

298. ILL. COMP. STAT. ch. 805, § 180/40-1.

299. *Id.* A plaintiff in any derivative action in Illinois must plead with particularity either the demand made to initiate the action or the reasons why demand would have been futile. See ILL. COMP. STAT. ch. 805, § 180/40-10; ILL. COMP. STAT. ch. 805, § 5/7.80(b); ILL. COMP. STAT. ch. 805, § 210/1003.

300. ILL. COMP. STAT. ch. 805, § 180/40-5.

301. *Id.* § 180/40-15.

302. Compare ILL. COMP. STAT. ch. 805, §§ 180/40-1 to -15 with ILL. COMP. STAT. ch. 805, § 210/1001-04.

303. ILL. COMP. STAT. ch. 805, § 210/1001 (emphasis added).

304. See *id.* § 210/1001.

305. See Keatinge, *supra* note 1, at 392-93.



porate statute on several procedural issues. First, any corporate derivative action settlement must be approved by the court.<sup>306</sup> Furthermore, unlike the LLC and limited partnership acts, the corporate statute does not expressly provide for the court to award reasonable expenses to derivative action plaintiffs. Finally, the corporate act permits a broader range of proper plaintiffs than does either the ILLCA or ILPA by allowing a shareholder who acquired shares after the occurrence of the transaction at issue to bring suit, provided that the shareholder acquired the shares before there was disclosure to the public or the shareholder of the misconduct at issue.<sup>307</sup>

### *I. Merger*

In contrast to the business corporation act,<sup>308</sup> the Illinois LLC, limited partnership, and general partnership acts do not specifically address mergers between their respective entities and other organizations. A growing number of other state LLC statutes now include provisions that expressly allow LLCs to merge with other entities, including other LLCs.<sup>309</sup> Statutory provisions permitting LLC mergers could play a significant role in facilitating the conversion of existing corporations into LLCs. There appears to be no persuasive reason to prohibit LLC mergers or to distinguish LLC mergers from the general merger rules applicable to corporations.<sup>310</sup>

Ironically, the reason that the ILLCA does not contain a merger provision relates directly to the primary advantage that a merger provision would create. The lack of a merger provision in the ILLCA apparently arose out of the legislature's fear of losing tax revenue.<sup>311</sup> Because the state franchise tax is imposed on corporations<sup>312</sup> but not on LLCs, by not including a merger provision in the ILLCA, Illinois has made it more difficult for existing closely held corporations to become limited liability companies,<sup>313</sup> and less likely that the state will

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306. ILL. COMP. STAT. ch. 805, § 5/7.80(c).

307. *Id.* § 5/7.80(a).

308. *See id.* §§ 5/11.05-11.75.

309. *See, e.g.,* ARIZ. REV. STAT. ANN. § 29-752 (Supp. 1992); KAN. STAT. ANN. § 17-7650; UTAH CODE ANN. § 48-2b-149.

310. For a further discussion of LLC mergers see Keatinge, *supra* note 1, at 394, 403.

311. Interview with Barbara C. Spudis, Chairperson of the American Bar Association's Section of Taxation Task Force on Limited Liability Companies (Oct. 25, 1993).

312. ILL. COMP. STAT. ch. 805, § 5/15.05(c).

313. Due to the lack of a merger provision, to convert a corporation into an LLC, an existing Illinois corporation must first organize a new LLC, then liquidate the existing corporation, and finally, transfer all of its assets to the newly organized LLC. The primary drawback to this liquidation process is that gain is generally taxed at the federal

lose franchise tax income from the conversion of existing franchise tax payors.<sup>314</sup>

In contrast to the ILLCA, the Illinois Business Corporation Act establishes detailed rules governing corporate mergers.<sup>315</sup> These provisions include: specific procedures to be followed in order to effect a merger, consolidation, or share exchange;<sup>316</sup> rules relating to shareholder approval;<sup>317</sup> a requirement that the articles of merger must be filed with the Secretary of State;<sup>318</sup> rules allowing and governing short form mergers;<sup>319</sup> rules governing asset sales;<sup>320</sup> extensive rules governing dissenters' rights;<sup>321</sup> and rules regulating business combinations with interested shareholders.<sup>322</sup>

Adding a merger provision to the ILLCA without further providing the extensive rules regarding dissenters' rights and combinations with interested shareholders that are in the IBCA would give Illinois LLCs an advantage over companies in other states,<sup>323</sup> while recognizing the fundamental partnership nature of LLCs. Given the partnership nature of LLCs, however, including these detailed provisions in the ILLCA might be inappropriate. Arguably, dissenters' rights are more important in widely held entities where individual owners are often unable to protect their interests adequately.<sup>324</sup> Since LLCs, particularly member-managed LLCs, are likely to be closely held, LLC members are more apt to be capable of protecting their interests through unanimous con-

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level to both the corporation and the shareholders in a corporate liquidation, *see* I.R.C. §§ 331, 336 (1988 & Supp. V 1993), thus subjecting any gain to double taxation. *See supra* notes 7-14 and accompanying text.

314. Another option would be to include a merger provision in the statute but also impose the franchise tax on LLCs. This would save any lost income to the state but permit LLC mergers. Seemingly, the drafters of the bill considered this alternative, but were opposed to the franchise tax on LLCs. Interview with Barbara C. Spudis, Chairperson of the American Bar Association's Section of Taxation Task Force on Limited Liability Companies (Oct. 25, 1993). Presently, the statute does not impose the franchise tax on LLCs, but also does not allow LLC mergers.

315. *See* ILL. COMP. STAT. ch. 805, §§ 5/11.05-.75.

316. *Id.* §§ 5/11.05-.10.

317. *Id.* §§ 5/11.15-.20.

318. *Id.* §§ 5/11.25, .45.

319. ILL. COMP. STAT. ch. 805, § 5/11.30.

320. *Id.* §§ 5/11.55-.60.

321. *Id.* §§ 5/11.65-.70.

322. *Id.* § 5/11.75.

323. The inclusion of a merger provision is advantageous because it would permit existing close corporations to become LLCs with less complexity than is possible in states lacking such a provision.

324. *See* Keatinge, *supra* note 1, at 394 ("[V]oting rights alone may not be enough to protect small passive shareholders.").

sent requirements or the exercise of their withdrawal rights.<sup>325</sup>

### *J. Recognition of LLCs in Foreign Jurisdictions*

One of the most troubling issues facing LLCs is whether other states will recognize and respect the status of LLCs formed under the Illinois statute.<sup>326</sup> This is potentially problematic because states that do not have LLC statutes might not recognize the limited liability of members of foreign LLCs.<sup>327</sup> Most states that have enacted LLC legislation therefore include provisions permitting LLCs organized under other states' LLC statutes to register to do business in that state.<sup>328</sup> Even though a majority of states have now adopted such legislation, recognition in those states lacking such legislation remains a major concern for foreign LLCs. The ILLCA expresses the intent of the Illinois legislature that Illinois LLCs should be legally recognized entities outside Illinois and be granted protection under the Full Faith and Credit Clause<sup>329</sup> of the Federal Constitution.<sup>330</sup> Unfortunately, this provision of the ILLCA does not bind the courts of other jurisdictions. Some commentators have suggested that LLCs might be permitted to transact business in states lacking LLC foreign recognition provisions under those states' foreign limited partnership or foreign corporation statutes.<sup>331</sup> It is uncertain, however, whether some states will allow LLCs to transact business under these other statutes.<sup>332</sup>

In Illinois, a foreign limited liability company<sup>333</sup> will be admitted to transact business upon application to and admission by the Illinois Secretary of State.<sup>334</sup> Once admitted, a foreign LLC must maintain a registered agent within Illinois and file annual reports with the

325. *Id.*

326. For an in-depth discussion of the problems of foreign recognition of LLCs, see *id.* at 447-56; Gazur & Goff, *supra* note 1, at 427-37.

327. See Keatinge, *supra* note 1, at 447-56; Gazur & Goff, *supra* note 1, at 427-37.

328. See, e.g., ILL. COMP. STAT. ch. 805, § 180/45-1; VA. CODE ANN. § 13.1-1051; UTAH CODE ANN. § 48-2b-144 (1953).

329. U.S. CONST. art. IV, § 1.

330. ILL. COMP. STAT. ch. 805, § 180/1-55.

331. See Gazur & Goff, *supra* note 1, at 429; see also Keatinge, *supra* note 1, at 448.

332. See Gazur & Goff, *supra* note 1, at 429.

333. The ILLCA defines a foreign limited liability company as either: (i) an unincorporated entity formed under a comparable statute of another United States jurisdiction; or (ii) a similar entity formed under a foreign country's statute as determined by the Secretary of State. ILL. COMP. STAT. ch. 805, § 180/1-5. This provision appears to accord substantial discretion to the Secretary of State to make a subjective determination of the status of a foreign entity.

334. See ILL. COMP. STAT. ch. 805, §§ 180/45-1 and 45-5.

Secretary of State.<sup>335</sup> The organization, internal affairs, and liability of members in foreign LLCs are to be governed by the laws of the jurisdiction under which the foreign LLC is formed.<sup>336</sup>

Although a foreign LLC that is not admitted to transact business in Illinois may not maintain a civil action in Illinois,<sup>337</sup> the failure to be admitted does not impair the validity of any act or contract of the foreign LLC or prevent the LLC from defending any civil action in Illinois.<sup>338</sup> Moreover, the members of a foreign LLC that has failed to gain admission are not personally liable for obligations of the LLC merely because the LLC transacted business in Illinois without admission.<sup>339</sup> Nevertheless, a foreign LLC that has failed to gain admission prior to transacting business in Illinois is liable for all fees that would have been imposed if the LLC were admitted and may be subject to penalties in excess of \$1,000.<sup>340</sup> The Illinois Attorney General may also bring an action to restrain an unadmitted foreign LLC from transacting business in Illinois.<sup>341</sup>

The Illinois limited partnership and business corporation acts contain provisions governing foreign entities that are substantially similar to the ILLCA provisions. The most significant difference, of course, is that neither limited partnerships nor business corporations face the uncertainties of foreign recognition that LLCs face. Although a majority of the states have now enacted LLC statutes, no case law involving LLCs exists, and the existing statutes vary greatly from state to state. Unlike limited partnerships and corporations, no general agreement exists as to what constitutes a "limited liability company."<sup>342</sup> This presents a significant definitional problem because statutes generally define a foreign LLC as a limited liability company organized under another state's laws.<sup>343</sup> For example, ILLCA section 180/1-5 defines a foreign LLC to be an unincorporated entity formed under a statute of another jurisdiction "comparable" to the ILLCA; however, the ILLCA fails to give any guidance as to which factors might make another statute "comparable" to the Illinois statute.

Similar to an LLC, a foreign limited partnership or corporation may

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335. *Id.* § 180/45-30.

336. *Id.* § 180/45-1.

337. *Id.* § 180/45-45(a).

338. ILL. COMP. STAT. ch. 805, § 180/45-45(b).

339. *Id.* § 180/45-45(e).

340. *Id.* § 180/45-45(d).

341. *Id.* § 180/45-50.

342. *See Keatinge, supra* note 1, at 379.

343. *Id.* at 395.

not transact business in Illinois until the Secretary of State admits the foreign entity.<sup>344</sup> Once a foreign corporation has been admitted to transact business in Illinois, the corporation must maintain a registered agent in the state,<sup>345</sup> file all reports that the statute requires a domestic corporation to file,<sup>346</sup> and pay fees, taxes, and penalties similar to domestic corporations.<sup>347</sup> A foreign limited partnership admitted to transact business must comply with similar provisions.<sup>348</sup>

Foreign entities that have not been admitted to transact business may not maintain a civil action in Illinois,<sup>349</sup> and unadmitted foreign corporations are liable for all fees, franchise taxes, penalties and other charges that would have been imposed if the corporation had been admitted.<sup>350</sup> Furthermore, as with unadmitted LLCs, the Attorney General may bring an action to restrain an unadmitted foreign limited partnership from transacting business in Illinois.<sup>351</sup> In contrast, the Attorney General may only bring an action against an unadmitted foreign corporation to recover fees, taxes, penalties, and other charges due to the State, but has no express authority to restrain a foreign corporation from transacting business.<sup>352</sup>

At the same time, however, the failure to be admitted does not invalidate any act or contract of a foreign entity or prevent the foreign

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344. Compare ILL. COMP. STAT. ch. 805, § 180/45-5 with ILL. COMP. STAT. ch. 805, § 210/902 and ILL. COMP. STAT. ch. 805, §§ 5/13.05 and 13.20.

345. ILL. COMP. STAT. ch. 805, § 5/5.05(b).

346. *Id.* §§ 5/14.01-.35.

347. *Id.* §§ 5/15.10 (filing fees), 15.50-.60 (license fees), 15.65-.75 (franchise tax) and 16.05 (penalties for failing to file required reports, taxes, or fees).

348. See ILL. COMP. STAT. ch. 805, §§ 210/103(a) (requiring foreign limited partnerships to maintain a registered agent in Illinois), 210/1102 (requiring the payment of certain fees), 210/1108 (requiring biennial filing of renewal reports of previously filed documents), and 210/1109 (imposing certain penalties for delinquent filings or fee payments). General partnership statutes do not include foreign recognition provisions, and general partnerships therefore are not required to file an application to transact business in a foreign jurisdiction. Unlike corporations, limited partnerships, and LLCs, general partnerships do not file organizing documents with the Secretary of State upon their creation. Compare ILL. COMP. STAT. ch. 805, § 5/2.10, 2.15; ILL. COMP. STAT. ch. 805, § 210/201(a); and ILL. COMP. STAT. ch. 805, § 180/5-1(a) with ILL. COMP. STAT. ch. 805, § 205/6. Rather, general partnerships arise by operation of law when "two or more persons . . . carry on as co-owners a business for profit." ILL. COMP. STAT. ch. 805, § 205/6(1). Because general partnerships are not required to file organizing documents in the state in which they arise, it follows that they are not required to file documents for foreign recognition purposes.

349. ILL. COMP. STAT. ch. 805, § 5/13.70; ILL. COMP. STAT. ch. 805, § 210/907(a).

350. ILL. COMP. STAT. ch. 805, § 5/13.70.

351. ILL. COMP. STAT. ch. 805, § 210/908.

352. ILL. COMP. STAT. ch. 805, § 5/13.70.

entity from defending a civil action brought against it in Illinois.<sup>353</sup> As with LLC members, limited partners of an unadmitted foreign limited partnership are not liable as general partners solely because the partnership has transacted business in Illinois.<sup>354</sup> The IBCA, however, does not contain such a provision regarding shareholders of an unadmitted foreign corporation.

Finally, in contrast to the ILLCA, the IBCA and the ILPA, the Illinois general partnership act contains no provisions governing foreign general partnerships. The foreign recognition provisions of the ILLCA, IBCA, and ILPA are necessary to ensure that these entities retain the limited liability protection granted by their state of organization. Because general partnerships do not enjoy such protection from liability, foreign recognition provisions are not necessary for this purpose.

## VI. CONCLUSION

The limited liability company offers a substantial advantage over other types of business entities in Illinois by combining limited liability with pass-through federal income tax treatment. The LLC provides an especially attractive alternative where the requirements imposed on S corporations are cumbersome. The LLC is also an appealing option where no investors are willing to assume the liability of a general partner in a general or limited partnership. Furthermore, all LLC members may actively participate in the management of the business without jeopardizing their limited liability. This characteristic offers a profound advantage over a limited partnership, in which limited partners have little control over the management of the partnership.

The Illinois Limited Liability Company Act offers one of the most flexible LLC frameworks in the United States. This flexibility provides a valuable tool to careful planners who seek a business entity that is customized to the specific needs of its investors. At the same time, to avoid corporate tax classification under the Treasury Regulations, practitioners must exercise great caution when taking advantage of the ILLCA's statutory flexibility. Furthermore, because LLC legislation has not been enacted in all fifty states, use of the LLC for interstate business transactions raises questions of whether an LLC will be permitted to transact business in some foreign jurisdictions while retaining limited liability for members.

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353. ILL. COMP. STAT. ch. 805, § 5/13.70; ILL. COMP. STAT. ch. 805, § 210/907(a) and (b).

354. Compare ILL. COMP. STAT. ch. 805, § 180/45-45(e) with ILL. COMP. STAT. ch. 805, § 210/907(c).

Since the issuance of Revenue Ruling 88-76, the use of LLCs has flourished as the number of states adopting LLC legislation has increased dramatically. Although the LLC is a relatively new tool to business planners in the United States, with more certain tax treatment and growing acceptance among states, the future will bring greater viability to the LLC, making it the most advantageous alternative for many businesses.