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THURSDAY, JUNE 12, 2014

Chicago Daily Law Bulletin®

Volume 160, No. 116

Not all LLCs are created equal, so make sure yours matches your needs

For decades, the limited liability company has been an attractive option for business owners who wish to avoid both double taxation and liability for the business' debts.

With the Illinois Appellate Court decision of *Dass v. Yale*, Illinois has made clear that personal liability protection extends even to a manager's fraudulent statement made on behalf of the LLC.

In 1977, Wyoming became the first state to pass legislation allowing for an LLC. In 1994, Illinois followed Wyoming's lead by enacting the Illinois LLC Act. Today, more than 12,500 Illinois businesses have chosen to organize as LLCs to reap the benefits an LLC offers.

Limited liability

An LLC combines the personal liability protection of a corporation and the tax benefits and simplicity of a partnership. This means LLCs have the following advantages:

- No entity-level taxation — all taxes flow through to the individual members.
- No personal liability.
- Flexibility in management and allocation of profits and losses.

To maximize asset protection, clients are encouraged to form manager-managed LLCs (in contrast to member-managed LLCs) to help insulate members and managers from liability. However, in a majority of states, an LLC does not extend limited liability protection to members and managers who carry on an LLC's fraudulent acts.

Protection for managers

In *Dass v. Yale*, the Illinois Appellate Court took the opposite approach by shielding an LLC manager from personal liability for fraudulent statements made on behalf of the LLC.

Dass involved an action against a managing member of an LLC for alleged fraudulent statements made during the sale of a condominium unit, which turned out to have problems with its sewer lines. The court found that the manager was shielded from liability by Section 10-10 of the act.

In affirming the trial court's decision, the appellate court found three reasons to shield LLC managers from liability for their fraudulent statements:

- The act's plain language clearly indicates that "a member or manager of an LLC is not personally liable for the debts the LLC incurred."
- The act has not adopted the comments made by the Uniform Law Commission, which make a manager responsible for acts that are actionable in contract or tort if that person was acting in an individual capacity.
- The act does not include an exception found in the Uniform Limited Liability Company Act of 1996 Commentary that precludes from immunity liability on account of a manager's own conduct.

The *Dass* decision makes clear that Illinois LLCs have asset protection at the entity level and management level. Additionally, *Dass* establishes that a member's personal immunity for "debt, obligations and liabilities ... whether arising in contract, tort or otherwise" includes immunity for acts of fraud committed while acting as a member of the LLC. This sets Illinois apart from a majority of other states, including Delaware, that have not yet extended limited liability to fraudulent actions.

Yet even with *Dass*, the liability shield does not insulate LLC members for tortious acts committed outside their capacity as a member or manager, or if an LLC includes in its articles of organization a contrary provision providing fault. Thus, in light of *Dass*, entities doing business with LLCs in Illinois should require a provision holding members and managers liable for fraudulent actions made on behalf of an LLC.

THE BUZZ

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Multi-member LLCs

Some states have weakened the limited personal liability protection for single member LLCs. The Florida Supreme Court in *Shaun Olmstead, et al. v. Federal Trade Commission* found that personal creditors of an LLC owner could directly attack LLC assets.

To date, Illinois has not made a distinction between single- and multi-member LLCs. Clients are eager to form single-member LLCs because they are treated as disregarded entities, and all tax attributes are reflected on the single member's individual tax return. However, in light of *Shaun*, clients are encouraged to avoid single-member LLCs to maximize asset protection. The filing of an additional tax return at the entity level is a small inconvenience relative to the increased asset protection afforded by having multiple members.

Taxation as S-corporation

Clients often look to an S-corporation as a quick fix to form a new entity due to lower filing fees and the tax benefits associated with an S-corporation.

But S-corporations provide little asset protection. Like a partnership, an S-corporation is a flow-through entity where all tax attributes flow through to the individual shareholders. Unlike a partnership, however, an active owner in an S-corporation has fewer withholding requirements for Medicare and Social Security, which can translate to income tax savings. An LLC can file a Form 2553 election to the IRS to be treated as an S-corporation.

Based on the nature of the business (often attractive for service businesses) and related owners, it may make sense to form an LLC and file an election to have an LLC taxed as an S-corporation. Where applicable, an LLC taxed as an S-corporation allows for maximum asset protection and income tax minimization.

Operating agreements

Every LLC should have an operating agreement. Although the act does not require an operating agreement, without one the LLC is subject to the state's default rules, which are one-size-fits-all.

An operating agreement outlines the percentage of interest ownership, allocation of profits and losses and member and manager rights and responsibilities to help reduce confusion and disputes. Even in instances of a single-member LLC, an operating agreement helps bolster the argument that the entity has adhered to corporate formalities, further increasing asset protection.

Not all LLCs are created equal. Clients are encouraged to work with an attorney who regularly advises clients on these types of entities to make certain the structure meets the client's particular needs, maximizes asset protection and minimizes income taxation.

A special thanks to Chuhak & Tecson P.C. law clerk Jamie Levin for her contribution to this column.

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