

STUDY UNIT TWO

NONCORPORATE LIMITED LIABILITY ENTITIES

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The fundamental types of business structures for multiple-owner enterprises are the general partnership and the corporation. The most significant advantage of the **general partnership** is that it is a **pass-through entity** for tax purposes. Its most significant drawback is that the partners have **unlimited personal liability** for all partnership debts and losses. In contrast, a **corporation** provides its owners with limited liability, but its earnings are subject to double taxation.

Accordingly, additional business structures have emerged that combine the tax advantages of the general partnership with the liability limitations of the corporation. The three major noncorporate hybrid structures are discussed in this study unit. They are the limited partnership, the limited liability partnership (LLP), and the limited liability company (LLC). A corporate hybrid structure, the S corporation, is discussed in Study Unit 3.

2.1 LIMITED PARTNERSHIPS

1. **Definition.** A **limited partnership** has characteristics of both a general partnership and a corporation. It facilitates investments by those who want a financial interest in a commercial venture but who do not want a management interest or unlimited liability.
 - a. The limited partnership is a separate legal entity.
 - b. It is a partnership formed by two or more persons under a state statute. These statutes are based on the **Revised Uniform Limited Partnership Act (RULPA)**. A limited partnership has one or more general partners and one or more limited partners.
 - 1) The term **person** includes a natural person, general partnership, limited partnership, trust, estate, association, or corporation.
 - 2) A **general partner** assumes management of the partnership and has full personal liability for debts of the partnership.
 - a) In the majority of states, a general partner may be another partnership or a corporation.
 - 3) A **limited partner** is an investor who makes a contribution of cash or other property to the partnership in exchange for an interest in the partnership and is
 - a) Not personally liable for partnership debts
 - i) The limited partner's exposure to partnership liabilities is limited to his/her contributions to the partnership.
 - b) Not active in management of the partnership
 - c) Not automatically an agent of the partnership
 - 4) A person can be both a general partner and a limited partner with the rights and liabilities of each.
 - a) These interests are separately accounted for by the limited partnership.
 - b) A limited partner is not entitled to become a general partner.

2. **Formation.** Compared with the general partnership, the limited partnership has the disadvantage of requiring significant legal formalities for its creation.
- a. The RULPA requires that a written **certificate of limited partnership** (a document similar to a corporation's articles of incorporation) be filed as a public record with the secretary of state of the state in which it is organized. The certificate gives potential creditors **notice** of the limited liability of the limited partners.
 - 1) If a certificate is not filed, the organization is treated as a general partnership.
 - 2) A **certificate of amendment** may be filed for "any proper purpose" determined by the general partners. A certificate of amendment also must be filed within 30 days after certain fundamental changes:
 - a) Admission of a general partner
 - b) Withdrawal of a general partner
 - c) Continuation of the business after an **event of withdrawal of a general partner** (any of various events that result in voluntary or involuntary withdrawal, such as death, dissolution of a corporate general partner, incapacity, or transfer of all of the partner's interest)
 - 3) A **certificate of cancellation** is filed either after dissolution and the beginning of winding up or at any time when there are no limited partners.
 - 4) A **limited partnership agreement**, although not legally required, is also commonly executed by the partners. The agreement sets forth the rights and duties of the general and limited partners and the terms and conditions of operation, dissolution, and termination.
 - a) Absent a separate agreement, the certificate of limited partnership serves as the articles of limited partnership, and state law (the RULPA) fills in omissions in the agreement.
 - b. **Content of the limited partnership certificate.** This document must be signed by all general partners. However, it need not record capital contributions and other financial information. It contains
 - 1) The name of the limited partnership,
 - 2) The address of its office,
 - 3) The name and address of its agent for service of process,
 - 4) The name and business address of each general partner (but not of each limited partner),
 - 5) The latest date upon which the limited partnership is to dissolve, and
 - 6) Any other matters the general partners determine should be included.
 - c. **Date of formation.** A limited partnership comes into existence when the certificate of limited partnership is filed or at a later date specified in the certificate.
 - 1) **Substantial compliance** with the filing requirements suffices for creation of the limited partnership.
 - d. A limited partnership may **carry on any business** that a general partnership may conduct, with statutory exceptions (e.g., banking).
 - e. **Name.** To protect creditors, the name must include the words "limited partnership."
 - 1) The name ordinarily may not include the name of a limited partner.
 - 2) The name may not be deceptively similar to that of a corporation or another limited partnership doing business in the state.
 - f. A limited partnership must continuously maintain an **office** in the state.

- g. Certain **records** must be kept in the office.
 - 1) Names and addresses of the partners
 - 2) The certificate of limited partnership and any amendments
 - 3) Financial statements of the limited partnership for the last 3 years
 - 4) The written partnership agreement
 - 5) Income tax returns and reports (federal, state, and local) of the limited partnership, if any, for the last 3 years
 - 6) Events causing winding up if not included in the written partnership agreement
 - 7) Information about contributions if not included in the written partnership agreement
 - h. The limited partnership is required to maintain an office, keep records, and appoint an agent to ensure that the courts of the state have **jurisdiction** over the limited partnership. They constitute sufficient **minimum contacts** so that the limited partnership can be sued in the state.
 - i. To do business in any other state, the limited partnership must **register** as a **foreign limited partnership** with that state's secretary of state.
 - 1) The foreign limited partnership must make various disclosures and appoint an **agent** for service of process so that it can bring suit in the state.
 - 2) Registration requirements are similar for foreign limited partnerships and foreign corporations.
3. **Capitalization.** Like a general partnership, a limited partnership may be financed by the partners' **contributions** of cash, property, services, or promises to make such contributions. (But a limited partner's promise is not a legal obligation unless it is in a signed writing.)
- a. An advantage of the limited partnership is that it can attract greater financing than the general partnership because of the limited liability of the limited partners.
 - b. A disadvantage is that a limited partner's right of withdrawal of his/her capital contribution is restricted. It may be withdrawn upon the dissolution of the partnership, at the date specified in the certificate, upon 6 months' notice in writing to all the members, or with the consent of all the members but only if all creditors are paid or sufficient assets are available for creditors.
4. **Profits, Losses, Distributions, and Assignment of Partnership Interests**
- a. The written **partnership agreement** controls the sharing of profits, losses, and distributions.
 - 1) In the absence of such an agreement, they are shared in proportion to the **value of the partners' contributions** received (and not returned).
 - b. The **partnership interests** of general and limited partners are intangible personal property and are assignable. These interests are rights to share in profits and losses and to receive distributions.
 - 1) The **assignment of a partnership interest** does not dissolve the limited partnership or entitle the assignee to become a partner. However, although unlimited rights to assignment may enhance the ability of the firm to raise capital, restraints on assignment are often imposed by the partnership.
 - a) Limited partnership interests are securities subject to registration under **federal securities laws** and regulation by the **Securities and Exchange Commission (SEC)**. If the partners wish to sell these interests under an exemption from registration, ready assignability may prevent these interests from qualifying for such an exemption. An exemption may require restrictions on resale.

- b) Ready assignability of limited partnership interests also may cause the IRS to view the partnership as a corporation for **tax purposes**.
 - c) Consequently, the partnership agreement may restrict transfers.
 - 2) The **assignee** of a partnership interest is entitled only to receive the distributions owed to the assignor-partner.
 - a) However, the assignee of a partnership interest (limited or general) may become a limited partner if
 - i) All partners agree, or
 - ii) The partnership agreement gives the assignor the right to **confer limited partner status** on the assignee.
 - In this case, the assignee-limited partner is subject to the known liabilities (e.g., to make contributions) of the assignor. The assignor continues to be liable for promised unpaid contributions.
 - 3) The interest of a limited partner is subject to a **charging order** obtained by a creditor from a court for the payment of an unpaid judgment. The effect of the order is an involuntary assignment of the limited partnership interest to the creditor or a third party.
 - a) The judgment creditor does not become a limited partner as a result of obtaining a charging order.
- 5. **Taxation.** Like the general partnership, the limited partnership is a pass-through (nontaxable) entity. Hence, the partners report their shares of the limited partnership's taxable and deductible items on their personal returns.
 - a. The limited partnership files only an **informational return**.
 - b. A limited partner not only enjoys limited liability, but also avoids the double taxation to which corporate earnings are subject.
 - 1) The IRS considers whether a limited partnership is in substance a corporation. It evaluates factors, such as the transferability of interests and the assets and net worth of the general partners, to determine whether the limited partnership form should be disregarded for tax purposes.
 - a) For example, a **publicly traded partnership** is taxed as a corporation unless at least 90% of its gross income is passive income. However, it is not taxed as a corporation if it elects to be taxed at a rate of 3.5% of its gross income from the active conduct of a trade or business.
- 6. **Rights of Partners**
 - a. A **general partner** in a limited partnership has the same rights, duties, liabilities, and authority as a partner in a general partnership (see Study Unit 1).
 - b. A **limited partner** has no authority to **participate in management and control** of the business. Such participation and control causes loss of limited-partner status even if allowed by the partnership agreement.
 - 1) Control means participation in daily management decisions.
 - c. A limited partner has rights that protect his/her/its position as a passive investor but does not otherwise have the rights, duties (fiduciary, etc.), and liabilities of a general partner. Thus, without loss of limited liability status, a limited partner has the right to
 - 1) If granted by the partnership agreement, **vote** on any matter
 - 2) Withdraw from the partnership upon 6 months' notice or in accordance with the partnership agreement
 - 3) Do business with the partnership, e.g., make a secured loan to it

- 4) Inspect and copy the partnership records
- 5) Obtain financial information, tax returns, and, if just and reasonable, other partnership information
- 6) File a **derivative suit** on behalf of the partnership
- 7) Assign his/her/its partnership interest
- 8) Apply for dissolution of the partnership
- 9) Receive the fair value of the partnership interest upon withdrawal
- 10) Invest in competing limited partnerships
- d. A limited partner is **not** considered to have **participated in management and control** of the business solely by
 - 1) Serving as an employee, agent, or contractor for the limited partnership or a general partner
 - 2) Acting as a consultant to a general partner
 - 3) Acting as a guarantor of an obligation of the limited partnership
 - 4) Requesting or attending a partners' meeting
 - 5) Making proposals and approving or disapproving certain matters, such as
 - a) Dissolution and winding up of the limited partnership
 - b) Transfer of substantially all assets
 - c) Incurrence of debt not in the ordinary course of business
 - d) Changing the nature of the business
 - e) Admission or removal of a general or limited partner
 - f) Transactions involving a general partner's conflict of interest
 - g) Amendment of the partnership agreement or the certificate of limited partnership
 - h) Any other matters that the partnership agreement designates as subject to the limited partners' approval

7. Liabilities of Limited Partners

- a. Typically, the financial risk of a limited partner who does not participate in management and control of the business is limited to the partner's investment in the partnership. But a limited partner may incur personal liability for the firm debts if
 - 1) No limited partnership certificate was filed.
 - 2) The certificate contained a false statement at the time it was filed, and a person suffered loss by relying on the statement.
 - a) A general partner, but not a limited partner, will be liable if the information in the certificate becomes inaccurate subsequent to filing.
 - 3) (S)he knowingly permits his/her name to be used as part of the partnership name and is held out as a participant in management.
- b. Personal liability for participation in management and control is only to persons who reasonably believed the limited partner was a general partner.
- c. A person may contribute to a business in the **erroneous belief** that (s)he has become a limited partner.
 - 1) Such a person may avoid liability as a general partner by filing
 - a) An appropriate certificate of limited partnership or an amendment, or
 - b) A certificate of withdrawal from equity participation
 - 2) These measures are not effective to avoid liability to third parties who did business with the enterprise previous to the filing. However, the third parties must have had a good-faith belief that the person was a general partner.

8. **Termination.** A limited partnership goes through **dissolution and winding up** before it is terminated.
- a. A limited partnership can be dissolved upon any of the following events:
 - 1) The time or event specified in the limited partnership agreement occurs.
 - 2) All the partners agree, in writing, to dissolve.
 - 3) An **event of withdrawal** of a general partner occurs unless
 - a) The written terms of the agreement provide that the business may be carried on by the remaining general partners (if any).
 - b) All partners agree in writing within 90 days to continue the business and appoint one or more new general partners if necessary or desired.
 - 4) The limited partnership is dissolved by court order.
 - b. The limited partnership is not dissolved by the bankruptcy, incapacity, or death of a limited partner.
 - 1) The personal representative of the estate of a deceased limited partner does not become a substituted limited partner. However, (s)he has the rights and liabilities of a limited partner for the purpose of settling the estate.
 - c. After dissolution, winding up is done by a **general partner** who has not caused the dissolution. If there is no general partner to conduct the winding up, it may be performed by the limited partners or by some person designated by a court.
 - d. Assets, if any, are distributed first to **creditors**, including creditors who are partners. Remaining assets are then distributed as follows, except as otherwise provided in the limited partnership agreement:
 - 1) To current and former partners for **distributions** previously due them and unpaid
 - 2) To the partners as a return of their **contributions**
 - 3) To the partners for their **partnership interests** in the proportions in which they share distributions
 - e. The final distribution terminates the limited partnership.

2.2 LIMITED LIABILITY PARTNERSHIPS (LLPs)

- 1. **Definition.** An LLP is essentially a general partnership with limited liability for the partners. It is a creation of state law. The LLP is a business structure that is often adopted by providers of professional services (e.g., attorneys, CPAs, and physicians) and family enterprises.
 - a. Except for the filing requirements discussed on the next page, an LLP is ordinarily treated as a legal entity to the same extent as a general partnership.
- 2. **Formation.** A disadvantage of the LLP is that its creation and continuation require compliance with statutory provisions.
 - a. For an existing partnership, changing to LLP status is equivalent to **amending the partnership agreement**. Thus, the partners must elect (often unanimously) to make the change in accordance with the agreement.

- b. Under the RUPA, partners must register by filing a **statement of qualification** with the secretary of state to become an LLP.
 - 1) An LLP, or a **foreign LLP** authorized to transact business in the state, also must file an **annual report** containing substantially the same (but updated) information as the statement of qualification (name, jurisdiction where formed, and facts sufficient for service of process).
 - 2) Errors or later changes in the information in the statement of qualification have no effect on status as an LLP or the liability of partners, but failure to file an annual report may result in revocation of LLP status.
 - a) The result may be a gap in the liability shield. Nevertheless, a corrective filing within 2 years will cure the gap because it relates back to the date of revocation.
 - 3) The end of an LLP's **name** must alert persons dealing with it to the existence of the liability shield (e.g., Registered Limited Liability Partnership).
 - 4) All of the foregoing requirements are intended to provide clear **notice of limited liability status** to those who do business with an LLP. Creditors will adjust their assessments of creditworthiness accordingly.
3. **Capitalization.** Like a general partnership, an LLP is financed by partner contributions and the entity's borrowings.
 - a. An advantage of an LLP is that the limitation on the personal liability of partners may attract additional capital.
4. **Profits, losses, distributions, and assignment of LLP interests.** The rules governing these matters that apply to general partnerships ordinarily also apply to LLPs.
 - a. However, assignments of LLP interests raise the same federal securities law and tax issues as assignments of limited partnership interests. Thus, restrictions on assignment may be necessary to retain the tax advantages of the LLP.
5. **Taxation.** Like other partnerships, an LLP is a pass-through (nontaxable) entity. Hence, the partners report on their personal returns their shares of the LLP's taxable and deductible items.
 - a. The LLP files only an **informational return**.
 - b. Consequently, all partners in an LLP not only enjoy limited liability but also avoid the double taxation to which corporate earnings are subject.
6. The **rights, duties, and authority** of partners in an LLP are similar to those of general partners.
 - a. The **management** of an LLP is facilitated because outside parties who do business with partners have notice by public filing of the limitation on personal liability.
7. **Liability.** The RUPA provides for a shield from personal liability for any partnership obligation (whether arising out of a contract, a tort, or otherwise) incurred while the partnership was an LLP. Unlike the limitation on liability in a limited partnership, the liability shield in an LLP protects the partners who manage the business.
 - a. The shield is created even if the partnership agreement contains an inconsistent provision just prior to the vote to become an LLP.
 - b. However, a partner who personally incurs an obligation, including liability for negligence and malpractice, in the conduct of partnership business is fully liable. The shield is provided only for liability that is imputed simply because a partner is a partner, not for liability directly incurred by the partner.
 - 1) Moreover, the supervisor of a person who commits negligence or malpractice (or other wrongful act within the scope of employment) also is liable. Depending on the statute, the liability may be (a) joint and several or (b) proportionate.

- c. As a condition of granting LLP status, some states require the firm to obtain **liability insurance**.
 - d. A **choice of law** issue arises when a **foreign LLP** (one that was formed in another state) does business in a state.
 - 1) Because the liability shield may vary from state to state, the RUPA provides that the law of the **state of formation** controls.
 - 2) The RUPA also provides that a **statement of foreign qualification** may not be denied because of differences in state law.
8. **Termination** of an LLP involves the same process (dissolution and winding up) as in a general partnership.

2.3 LIMITED LIABILITY COMPANIES (LLCs)

1. **Definition.** An LLC is a noncorporate hybrid business structure that may be formed only under a **state statute**. It combines the limited liability of the corporation with the tax advantages of the general partnership.
 - a. The uniform act is the **Uniform Limited Liability Company Act (ULLCA)**. However, the ULLCA has not been adopted by a majority of jurisdictions, and state laws vary. Thus, business law textbooks emphasize the common aspects of state laws and the ULLCA.
 - b. Like a corporation, a limited partnership, and an LLP, an LLC is a **legal entity** separate from its owners that can be created only under state law.
 - 1) An LLC may enter into contracts, sue, be sued, own property in its own name, engage in other transactions in property, make donations, be a general or limited partner, and appoint agents.
 - 2) The owner-investors (**members**) may file **derivative suits** on behalf of the LLC, with any damages awarded by the court being paid to the LLC.
 - c. Like a partnership, the LLC may have owner management, a limited duration, and restricted transfer of interests.
 - d. Like the shareholders of a corporation but unlike the partner-managers of a limited partnership, the owners of an LLC who participate in management enjoy limited liability.
2. **Formation.** An LLC is formed by **one or more persons** who file **articles of organization** with the appropriate secretary of state (or the equivalent). Thus, formation is more difficult than for a sole proprietorship or a general partnership.
 - a. Some states require that an LLC have at least two members, but most state statutes (and the ULLCA) permit single-member LLCs.
 - b. The **name of the LLC** must indicate by words or abbreviations that it is an LLC.
 - c. The articles of organization should state the LLC's name. It should also
 - 1) Include certain basic information, such as the names and addresses of organizers, the initial agent for service of process, and initial managers;
 - 2) Provide for existence
 - a) For a specified **term** or
 - b) **At-will**;
 - 3) Indicate whether management will be by owners or managers; and
 - 4) State whether one or more members will be liable for the LLC's obligations.

- d. The members' **operating agreement**, which is not legally required and may be oral, may address matters such as
 - 1) Management arrangements,
 - 2) Voting rights (absent a contrary agreement, members, or managers in a manager-managed LLC, have equal voices),
 - 3) Member meetings,
 - 4) Profit sharing (absent a contrary agreement, statutes usually provide for equal sharing),
 - 5) Transfer of members' interests, and
 - 6) The circumstances causing dissolution.
 - e. The LLC comes into **existence** when the articles are filed. The filing is conclusive proof that the organizers met the conditions for creation of the LLC.
 - f. The LLC must at all times maintain an **agent** for service of process and an **office** in the state.
 - 1) These requirements are the same as for limited partnerships and corporations.
 - g. A **foreign LLC** must obtain a **certificate of authorization** to operate in the state.
 - 1) The requirements for obtaining the certificate are similar to those that must be met by a foreign LLP or a foreign corporation.
 - 2) However, the law of the state of formation is ordinarily followed with regard to the conditions for creation of the foreign LLC and member relations.
3. **Capitalization.** Funding of an LLC is from **members' contributions**. In the absence of an agreement to the contrary, it may consist of tangible and intangible property and services, including services to be performed.
- a. The advantages of limited liability and avoidance of double taxation may attract member-investors.
 - b. Other advantages are that an LLC may offer multiple classes of stock, and its members may be partnerships, corporations, and nonresident aliens.
 - 1) An **S corporation** (covered in Study Unit 3) does not offer these benefits.
 - 2) Moreover, unlike an S corporation, an LLC has no limit on the number of members, can make disproportionate allocations and distributions, and can distribute appreciated property without incurring a taxable gain.
 - 3) A member of an LLC can contribute appreciated property in exchange for a membership interest without recognizing a taxable gain.
4. **Profits, Losses, Distributions, and Transfer of LLC Interests**
- a. In the absence of a contrary agreement, profits and losses are shared equally.
 - 1) A member is not automatically entitled to compensation, except for winding up the enterprise.
 - b. The rules for distributions upon liquidation of the LLC or dissociation of a member are similar to those for partnerships (RUPA).
 - c. A member can transfer his/her **distributional interest**, which is essentially the member's portion of the net assets of the LLC.
 - 1) The member has no right in specific property of the LLC.
 - 2) The transfer may be involuntary, for example, via a charging order obtained by a creditor.
 - 3) The transfer also may be through the estate of a deceased member.
 - 4) A transferee does not become a member in the absence of consent of all members or a provision in their agreement.

5. **Taxation.** Members may elect to be taxed as partners, and single-member LLCs may be taxed as sole proprietors.
 - a. **Taxation as a corporation** may be advantageous if reinvestment in the LLC is desired and corporate rates are lower than personal rates.
 - b. Thus, an LLC has the advantage of being a pass-through entity or a taxable entity at the discretion of the member(s).
6. **Management.** An LLC is deemed to be member-managed unless the articles of organization provide otherwise.
 - a. Under the ULLCA, in a **member-managed LLC**, all members have a right to participate, and most business matters are decided by the majority.
 - b. In a **manager-managed LLC**, each manager has equal rights, and most business matters are decided by the manager or by a majority of the managers.
 - 1) Managers are selected or removed by a majority vote of the members and are fiduciaries regarding the LLC and the members. They have **duties** of loyalty, care, and good faith.
 - a) The members in a member-managed LLC have the same duties.
 - c. The ULLCA further provides that, in any LLC, members must **unanimously agree** about some matters, for example,
 - 1) Amending the operating agreement or the articles,
 - 2) Dissolution,
 - 3) Waiver of the right to have the business wound up,
 - 4) Merger, and
 - 5) Admission of new members.
 - d. Members have the right to inspect books and records and to be informed about the business.
 - e. If the articles vest management of the LLC in elected managers, they are **agents** of the LLC. Any one manager may therefore have the statutory authority to bind the LLC.
 - f. If the articles vest management in its members, they are agents. Thus, it may be possible, depending on the statute, for any one member to incur indebtedness or otherwise contractually bind the company.
 - g. Persons who conduct business as an LLC when statutory requirements for its formation have not been complied with do not have limited liability and are jointly and severally liable as partners.
7. **Liability.** A great advantage of an LLC is that the creditors of the entity ordinarily have no claim on the personal assets of the members or managers.
 - a. However, the members or managers remain liable for personal misconduct (e.g., negligence or criminal behavior). Moreover, misuse of the LLC form (e.g., to commit fraud or mislead others about who is conducting the business) may cause a court to “pierce the corporate veil.”
 - b. Federal and state laws also may provide other avenues for reaching personal assets. For example, the IRS may proceed against an individual for a fraudulent transfer or nonpayment of trust fund taxes, and a state may hold individuals liable for not providing workers’ compensation insurance.

8. **Termination.** Generally, subject to the LLC's solvency, a member is entitled to a return of his/her capital contribution upon dissolution or other specified event.
- a. An LLC will be **dissolved** upon
 - 1) Expiration of a specified time period or occurrence of a specified event
 - 2) Consent of a number or percentage of members provided in their agreement
 - 3) Death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member, or upon the occurrence of any other event that terminates the LLC under the articles or by the required consent of remaining members
 - 4) **Judicial determination** of
 - a) Frustration of purpose
 - b) Impracticability of continuing because of a member's conduct
 - c) Impracticability of continuing under the articles and operating agreement
 - d) Inappropriate behavior of controlling members or managers
 - e) The equitability of liquidation
 - b. Liquidation results in payment of proceeds in the following order:
 - 1) Outside creditors
 - 2) Loans from members
 - 3) Members' capital contributions
 - 4) Remaining amounts equally to members
 - c. If dissociation of a member does not cause dissolution, the LLC must purchase the member's interest at **fair value**.