

TITLE ISSUES

THE LIMITED LIABILITY COMPANY: A NEW WAY TO DO BUSINESS IN ILLINOIS

by Douglas M. Karlen
Assistant Regional Counsel

I. INTRODUCTION: WHAT IS A LIMITED LIABILITY COMPANY?

An Act that became effective January 1, 1994, creates a new form of business entity in Illinois known as the Limited Liability Company (LLC). The Act adds the LLC, a non-corporate form of doing business, to the menu from which investors may select an appropriate form for doing business in Illinois. This article will briefly describe the characteristics of an LLC and will consider title-related issues when an LLC becomes involved in a real estate transaction.

II. GENERAL CHARACTERISTICS: WHY AN LLC?

When investors choose to operate a business in the LLC form, they may achieve the following desirable benefits: (1) limited personal liability; (2) flexible management structure; (3) flexible distribution and profit/loss allocation scheme; and (4) the potential, depending upon the structure of the LLC, to receive federal income tax treatment as a partnership rather than as a corporation.

The LLC is a hybrid form of business entity. It resembles both a partnership and a corporation, depending upon the observer's perspective. To insiders, it resembles a partnership. To outsiders — the people with whom it does business, its creditors, and state government officials — it resembles a corporation. To the most important outsider, however, namely the Internal Revenue Service (IRS), the LLC may resemble either a partnership or a corporation, depending upon the provisions of the LLC governing documents. Since the Act permits variations in the contents of governing documents, the income tax treatment of each LLC must be considered on its own merit. Commentators suggest, however, that investors who choose to operate as an LLC require that their LLC governing documents qualify if the LLC for the flow through form of taxation is applicable to partnerships.

Generally, an LLC may engage in any lawful business except banking and insurance. The Act specifically confers on the LLC all normal business powers including, among other

things, the powers to purchase, lease, sell, and mortgage real estate. Commentators suggest that the LLC is well-suited for real estate holding and development ventures. The LLC may ultimately surpass the limited partnership as the business entity of choice in real estate transactions.

III. GOVERNING DOCUMENTS

A. Articles of Organization

One or more persons may organize an LLC by filing Articles of Organization with the Illinois Secretary of State. At the time of its organization, an LLC must have at least two owners, referred to in the Act as members. LLC members may be individuals, partnerships, corporations, trust, or any other entity including another LLC.

The Articles of organization must include the following information: (1) name and address of the LLC; (2) purpose of the LLC; (3) name of the LLC's registered agent and address of the LLC's registered office (both of which must be in Illinois); (4) names and addresses of the initial managers of the LLC or the names and addresses of the initial members if no managers will be appointed; (5) dissolution date or other events of dissolution; (6) names and addresses of the organizers; and (7) any other provisions, not inconsistent with the Act, for the internal organization of the LLC.

An LLC begins its legal life upon the filing of the Articles of Organization with the Secretary of State or upon any later date specified in the Articles of Organization. The Act does not require filing the Articles of Organization with a Recorder of Deeds.

B. Operating Agreement

The Act requires that only the bare necessities of a business entity be included in the Articles of Organization. The complex relationships between members are governed by the Act, but the Act does permit members to manage and regulate the LLC by other methods that are not inconsistent with the Act. Thus, members may wish to memorialize their relationships and understandings in a separate agreement, referred to in the Act as an Operating Agreement. The Act does not require the

execution of an Operating Agreement, nor does it require, if one is executed, that it be filed with the Secretary of State or be recorded.

Among the topics appropriate to an Operating Agreement, the following may be the most important: (1) delegation of management responsibilities to persons who may or may not also be members; (2) capital contributions of members; (3) methods of financing LLC operations; (4) distributions of LLC profits; (5) expansion of membership; (6) resignation of members; (7) transfer of membership interests; (8) dissolution of the LLC; and (9) members' rights in derivative actions.

IV. INCOME TAX TREATMENT: THE HEART OF THE MATTER

Treatment as a partnership for federal income tax purposes may be the principal reason why investors choose to form an LLC. Organizers may require that the LLC's governing documents establish an entity that will be taxed as a partnership rather than as an association taxable as a corporation. Drafters must consider the following test applied by the IRS: (1) in analyzing the tax status of any unincorporated entity, the IRS evaluates the entity's structure with respect to four corporate characteristics: (2) limited liability; continuity of life; fee transferability of interests; and centralization of management. If an entity exhibits any three of the four characteristics, the IRS considers it to be an association taxable as a corporation. Conversely, if the entity lacks any two of the four characteristics, the IRS deems it to be taxable as a partnership.

While an Illinois LLC will obviously exhibit the corporate characteristic of limited liability and may frequently exhibit the corporate characteristic of centralization of management, it may lack the corporate characteristics of continuity of life and free transferability of interests. Thus, the tax status of each LLC must be considered in light of the Act and the LLC governing documents on a case-by-case basis.

A. Limited Liability

The corporate characteristic of limited liability exists when no member of the business entity is personally liable for the debts of the entity. Under the Act, LLC members and managers are not liable in any manner for any debt, obligation, or liability of the LLC, or of each other, except to the extent they would be liable as shareholders and directors of an Illinois business corporation. Thus, an LLC should always possess the corporate characteristic of limited liability.

B. Continuity of Life

An entity lacks the corporate characteristic of continuity of life when any member has the power to dissolve the entity through death, retirement, insanity, bankruptcy, expulsion, or other event of withdrawal, even if the remaining member agree to continue the business. The Act permits flexibility in drafting dissolution provisions in the LLC governing documents. LLC organizers who wish to take advantage of the Act's flexibility must carefully consider the possibility that unique dissolution provisions may create an LLC with the corporate characteristic of continuity of life.

C. Free Transferability of Interests

The corporate characteristic of free transferability of interests exists when any member has the power, without the consent of the other members, to substitute a non-member in his or her place, conferring all attributes of ownership on that non-member. The Act provides that unless stated otherwise in the governing documents, a member cannot assign to a non-member the right to participate in the management of the LLC without the consent of all other members. A member may freely transfer membership interests in profits but not in management or voting rights. Once again, the flexibility permitted under the Act must be carefully considered in order to avoid undesired results.

D. Centralization of Management

An entity possesses the corporate characteristic of centralization of management if a person, or group of persons which does not include all the members of the entity, is vested with the exclusive authority to make business decisions for the entity. An LLC could possess centralization of management if the members delegate management responsibilities to a manager or management group. The Act allows members to delegate management duties in the governing documents. Thus, the choice to be member-managed or manager-managed may be crucial for tax planning when other provisions in the governing documents may have established continuity of life or free transferability to interests.

V. TITLE-RELATED ISSUES: ON BEING AND DOING

Anyone who transacts business with an LLC should inquire into the legal existence of the LLC and into the authority of the managers of the LLC to consummate the subject transaction. Title companies will not be an exception to this common sense rule. Thus, whenever an LLC participates in a real estate transaction that will be insured by Chicago Title Insurance Company, counsel for the LLC should, in addition to all standard title documentation, assemble proof of the LLC's existence and proof of the managers' authority to act. Chicago Title will request the items discussed below whenever an LLC is involved, regardless of whether the LLC is buying, selling, mortgaging, leasing, or participating in a real estate transaction in any other capacity.

A. Existence

For an Illinois LLC, legal existence begins when its organizers file Articles of Organization with the Illinois Secretary of State. Chicago Title should, therefore, be furnished a copy of the Articles of Organization, together with all amendments thereto, and evidence that the Articles have been filed with the Secretary of State. A copy of the Articles bearing the Secretary of State's file number should suffice. In addition, Chicago Title will request certification from Counsel that no event of dissolution has occurred.

For an LLC organized under the laws of another state, the Act requires that any such foreign LLC must be admitted to do business in Illinois. Admission is accomplished by filing documents specified in the Act with the Secretary of State. Thus,

with a foreign LLC, Chicago Title should be furnished with evidence of legal existence in the LLC's home state certification that no dissolution has occurred, and evidence that the foreign LLC has been admitted to do business in Illinois.

B. Authority

The Act allows for flexibility in the LLC's management structure. Thus, the LLC may be managed by all of its members or by managers designated by the members. The designation may be made either in the Articles of Organization or in an Operating Agreement. To insure title based on any act of an LLC, Chicago Title will, therefore, need to know whether the LLC is member-managed or manager-managed. Counsel for the LLC should furnish Chicago Title with the following: (1) Articles of Organization, together with all amendments thereto; (2) operating agreement, if one exists, together with all amendments thereto (or at least the portions of the Agreement that designate managers and describe the managers' powers); (3) for a member-managed LLC, a list of incumbent members, in the event of change since the LLC's organization; and (4) for a manager-managed LLC, a list of incumbent managers, in the event of change since the LLC's organization. With the foregoing information, Chicago Title will be able to determine whether the contemplated transaction falls within the LLC's business purpose and whether the persons executing transactional documents have appropriate authority. For an extraordinary business transaction, however, Chicago Title may require, in addition to the foregoing information, appropriate resolutions by the LLC members authorizing transactions such as, for example, sale of all or substantially all of an LLC's assets or sale of LLC assets to a manager or member. In the ordinary course of business, however, the four items specified above will, if in good order, enable Chicago Title to insure any estate or interest in land derived through an act of an LLC.

VI. CONCLUSION: FOR MORE INFORMATION...

This article is only a brief discussion of LLC characteristics and title-related issues. Much more could be and has been written about LLC's. For further information about title matters, contact any Chicago Title underwriting counsel. For official forms, filing information, general information, and proof of filings, contact the Illinois Secretary of State at the following address:

Office of the Secretary of State
Department of Business Services
Limited Liability Company Division
Room 357, Howlett Building
Springfield, IL 62756
Telephone: (217) 524-8008

FOOTNOTES

1. The Limited Liability Company Act, P.A. 87-1062, codified at 805 ILCS 180/1-1 et seq. (Act).
2. The menu already includes corporations, general partnerships, limited partnerships, trusts, joint ventures, etc.
3. Provisions within LLC governing documents will determine eligibility for these benefits.
4. The Act allows for informal operating structure, limited duration, and restrictions on transferability of interests — all typical partnership characteristics.
5. The Act allows for limited personal liability of investors and required filings with government officials—typical corporate characteristics.
6. Investors in partnerships face the tax bite only when income flows through the partnership to the partners. Partnership income, by itself, is not taxed. Investors in corporations, on the other hand, face two tax bites the first on corporate income and the second on individual income in the form of dividends or salaries.
7. Section 1-25 of the Act.
8. Section 1-30 of the Act grants to an LLC the rights to sue and be sued, purchase, sell, lease, and mortgage real or personal property, lend or borrow money, invest funds, conduct its business, elect managers and appoint agents, establish deferred compensation plans, and become a member of a general partnership, limited partnership, joint venture, or another LLC.
9. See Section 5-1 of the Act.
10. See generally, Section 5-5 of the Act. See also Section 1-10 of the Act (The name of the limited liability company must include the words "Limited Liability Company" or "L.L.C.").
11. Section 5-40 of the Act.
12. See generally, Section 15-5 of the Act. Unless provided otherwise in the Articles of Organization or Operating Agreement, the topics listed in the text will be governed by various provisions of the Act. All agreements among members shall be "not inconsistent" with the Act.
13. See generally Treas. Reg. Sec. 301-7701-2. See also Revenue Ruling 88-76, analyzing an LLC organized under the Wyoming LLC statute (the first in the United States) and Revenue Ruling 93-49 analyzing the Illinois Act.
14. Section 10-10 of the Act.
15. Section 35-1 of the Act provides that an LLC shall be dissolved upon the happening of the first to occur of any of the following: (1) an event specified in the Articles of Organization; (2) the written agreement of the members; (3) unless otherwise provided in the Articles of Organization or Operating Agreement, upon the death, retirement, resignation, bankruptcy, dissolution, or incompetence of a member, unless within 90 days after the event there are at least two remaining members and all the remaining members agree to continue the business of the LLC; (4) an entry of a judicial decree of dissolution; or (5) and entry of an administrative dissolution. Presumably, an LLC organized strictly in accordance with the Act and without embellishment in its governing document will lack the corporate characteristic of continuity of life.
16. Section 30-5 of the Act. Presumably, an LLC organized strictly in accordance with the Act and without embellishment in its governing documents will lack the corporate characteristics of free transferability of interests.
17. Section 15-1 of the Act.
18. See generally Section 45-1 et seq. of the Act.