

**LIMITED LIABILITY COMPANIES AND  
LIMITED LIABILITY PARTNERSHIPS IN ILLINOIS:**

**PRACTICAL OPERATING ISSUES**

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The limited liability company ("LLC") and the limited liability partnership ("LLP") have become popular choices for both new and existing businesses. Both entities limit the liability of their owners, while passing through tax attributes without a second tier of tax. An attractive feature of both types of entities is organizational flexibility. With flexibility, however, comes new challenges. In Illinois, as in most jurisdictions, the statutes will control the operation and management of the business absent an operating agreement negotiated by its members or partners. But the statutory default provisions are often not what the members or partners would choose if asked. The practitioner and his or her clients must take time to plan and draft the governing documents (operating agreement for an LLC and partnership agreements for an LLP) to meet the specific needs of the client.

This section will review some of the more important business issues which should be addressed in an LLC operating agreement. Although the partnership agreement of an LLP will not be discussed specifically, most of the issues are universal (and are, in fact,

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issues in closely held corporations as well). At the end of this section is a sample operating agreement for an Illinois member-managed LLC to help put some of the issues in focus. Since the sample is taken from an actual operating agreement, various issues have been addressed in ways that will not be applicable to other LLCs in other situations. The sample is not intended, therefore, to be a "model" agreement but simply an illustration of how one Illinois member-managed LLC addressed the issues important to it.

**I. Voting and Governance Issues.**

**A. Form of Management.** An LLC may be managed directly by its members or by one or more managers. In Illinois, the initial decision of whether an LLC is to be member managed or manager managed is required at the time of the articles of organization are filed. In Delaware, by contract, any LLC may be managed by a manager and no provision is required in the Certificate of Organization.

**(1) Member-Managed.** An LLC may be managed directly by its members. In a member managed company, each member has equal rights in the management and conduct of the companies business. 805 ILCS 180/15-1(a). Except as specified in section 15-1(c) which will be discussed later, any matter relating to the business of the company may be decided by a majority of the members. In a member-managed LLC, each member is an agent of the LLC for the purpose of its business, and an act of a member, including signing an instrument in the company's name, generally binds the

company. 805 ILCS 180/13-5. This is distinguished from a manager-managed LLC, where the member is not an agent of the company.

(2) **Manager-Managed.** An LLC may also choose to be managed by one manager or a group of managers. This form of management is similar to the corporate structure where shareholders elect directors to manage the day-to-day affairs of the business. In a manager-managed LLC, members do not participate in the day-to-day management of the company. The number of managers and method by which they are appointed or elected is not specified in the statute, so the operating agreement must fill the gap.

While the manager has day-to-day control of the LLC, the operating agreement may limit the authority of the manager and require member approval on key business decisions. However, the manager is, by law, an agent of the company and has the power to bind the LLC by any act that is in the ordinary course of business unless the third party has knowledge that the manager lacks actual authority to bind the company.

The operating agreement should also provide a method for removing the manager. A manager may be removed by a majority vote of the members of the company (805 ILCS 180/15-1).

**B. Matters in Which Members May Vote.** The voting rights of members may be broad or limited in scope (*e.g.*, following either a partnership or corporate structure), or some membership interests may not have voting rights at all. If broad rights are to be provided, consideration should be given to the procedure which is to be

followed in obtaining such approval (*e.g.*, via meeting or written consent). Matters which are often considered significant for voting rights purposes are as follows:

- (a) Appointment of a manager
- (b) Admission of new members
- (c) Issuance of new interests to existing members
- (d) Amendments to the operating agreement
- (e) Sale of the business or a substantial portion of the assets
- (f) Merger or combination with another business
- (g) Approval of an annual budget
- (h) Dissolution of the company
- (i) Distributions to members
- (j) Borrowing money

**C. Voting Rights.** Voting may be done on a per member basis, by membership interest or in classes. If there are multiple classes of membership interests, those classes may be afforded different voting rights.

**D. Approvals.** The default rule for an LLC only requires a majority approval for most actions in connection with the business and affairs of the LLC (805 ILCS 180/15.1(a)(2)). The operating agreement should specify whether a majority, supermajority or unanimous consent is required for a particular matter.

**E. Admission of New Members.** Under 805 ILCS 180/15.1(c) unless otherwise stated in the operating agreement, a new member may not be admitted in the

LLC without the unanimous consent of the other members. The agreement should specify the procedure for admitting new members and set forth the approval required, *e.g.*, unanimous, supermajority, majority or consent of the manager.

**F. Voting Rights of a Transferee.** If the LLC permits a member to transfer his or her interests to a third party, the transferred interest will include the member's right to share in the profits and losses of the company and the right to receive distributions from the company, but the assignee may not participate in the management of the business unless he or she is admitted as a member.

**G. Meetings.** Should members have regular meetings? If so, how often? Should special meetings be allowed? If so, who should be authorized to call special meetings? If special meetings are permitted, the operating agreement should also specify the notice procedures for calling the meeting.

## **II. Ownership Issues**

**A. Restrictions on Transfers of Interests.** A member is not a co-owner of, and has no transferable interest in, property of a limited liability company, but his distributional interest in a limited liability company is personal property. The general default rule is that the member's distributional interest may be transferred in whole or in part. A transfer of a distributional interest does not entitle the transferee to become or to exercise any rights of a member. A transfer entitles the transferee to receive, to the extent transferred, only the distributions to which the transferor would be entitled. 805 ILCS 180/30-5. A transferee who does not become a member is not entitled to

participate in the management or conduct of the limited liability company's business, require access to information concerning the company's transactions, or inspect or copy any of the company's records. 805 ILCS 180/30-10.

Under Section 708 of the Internal Revenue Code (the "Code"), a partnership is terminated for tax purposes upon the sale or exchange of 50% or more of the partnership interests. Thus, if the members have not imposed other restrictions on transfer, members of an LLC that has elected partnership tax treatment should, at a minimum, prohibit any transfer that would violate Section 708, unless there is approval by all, or at least a majority, of the members.

The operating agreement should also address rights of first refusal and other transfer restrictions. The extent to which transfers to relatives or affiliates of a member should be exempt from these transfer restrictions should also be covered. Finally, any transfer restrictions should contain a reference to federal and state securities laws in order to ensure compliance.

**B. Buyout Provisions.** Any operating agreement should address the circumstances under which a member's interest may be bought out by the entity or by the other members. In Illinois, the default rule is that the LLC must cause the dissociated member's interest in the LLC to be purchased. 805 ILCS 180/35-55. However, the operating agreement can change that rule and address any other events that the participants may wish to trigger a buyout of a member's interest.

Some events which the members may wish to consider include:

- (a) Death of a member
- (b) Disability of a member (if active in the operations or management of the entity)
- (c) Involuntary transfer of membership/ interest (such as bankruptcy or divorce)
- (e) Termination of employment

Once events which trigger the buyout have been determined, consideration should be given to purchase price obligations. Should all buyouts create the same or different purchase price obligations? For example, disassociating caused by death and disability may trigger a higher purchase price than disassociating resulting from a for-cause termination of employment.

The method of determining the buyout price should be specified. There are many ways to establish a price for a buyout. Two basic approaches are conducting an appraisal at the time of the event which triggers the buyout or incorporating a formula into the agreement at the time it is drafted. Another method is to require the members to agree on a fair value for the interests in the entity by executing and delivering a certificate once every year. If that method is selected, it is very important to build in a default valuation mechanism set forth in the agreement if the agreed valuation is out of date.

An example of a formula method is to apply a multiple of earnings before interest, taxes, depreciation and amortization. A formula might also be based on book value or some multiple of book value.

C. **Deadlock/Put-Call Provisions.** Some clients will want a provision to compel one member to sell to one or more other members upon the occurrence of certain events, such as a deadlock in management. The provision can be drafted to be entirely optional on the part of various members. Often, these provisions involve one member ("offeror") setting a price and the other members deciding whether to purchase the offeror's interest at that price or sell their membership interest to the offeror at the same price. These provisions are useful even though the process is rarely pursued to completion. Be careful to consider external circumstances that may affect the outcome, such as disparate financial positions among the participants, when drafting these provisions.

III. **Economic Rights of Members/Partners.**

A. **Allocation of Profit and Losses.** As a general rule, the members can agree to allocate profits and losses and cash distributions in any manner they choose, provided that the allocation method complies with Section 704(b) of the Code. This Section requires allocations of profit and losses to comport with the "substantial economic effect" of the underlying transactions giving rise to the profit or loss in order to be respected for tax purposes. However, if the members do not specify the method in which distributions will be made, 805 ILCS 180/25-1 provides that any distributions made by an LLC before its dissolution must be in "equal shares."

B. **Preferred Returns.** The members may decide to allow preferred returns for some members. If this is done, the agreement should clearly specify the method of

calculating the preferred return. Keep in mind that providing preferred returns to members will necessitate compliance by the entity with the provisions of Section 704(b) of the Code, as discussed above.

**C. Secondary Split.** If preferred returns are utilized, what sharing arrangement should apply after the preferred returns have been distributed? This typically is done on a percentage basis, but could be done on another allocation basis.

**D. Distribution Upon Sale of Business.** Should a different sharing arrangement be effective upon the sale of the business? For purposes of Section 704(b) of the Code, allocations and distributions will ultimately need to be made in accordance with the positive capital accounts of the members. This should be taken into account in structuring allocations associated with any distributions arising from a sale of the business.

**F. Mandatory Distributions.** Since the LLC is generally treated as a partnership for tax purposes, the members will be taxed on the income of the LLC, regardless of whether any cash was distributed. This may result in members incurring tax liability for their proportionate share of the company's income without receiving cash sufficient to pay the taxes. A mandatory tax distribution solves this problem. Members may also require distributions other mandatory distributions. For example, if some members are entitled to a preferred return, it is common to mandate payment of the return to the extent of "available cash flow".

**IV. Other Managerial Issues.**

**A. Indemnification.** The default rule is that the LLC is required to indemnify a member or manager, reimburse a member or manager for payments made and indemnify a member or manager for liabilities incurred by the member or manager in the ordinary course of the business of the company or for the preservation of its business or property. 805 ILCS 180/15-7. The agreement should specifically identify the indemnification obligations of the LLC. Consideration should be given to whether the obligation to afford indemnification should be absolute or conditional.

**B. Non-Competition Provisions.** The extent to which a manager or member can compete with the business of the LLC should be defined. A decision should also be made as to whether such obligations should continue beyond the date such person ceases to be a manager or member in the entity concerned, *e.g.*, should it be an employment or membership-based obligation.

**C. Confidentiality Provisions.** Trade secrets and other proprietary information are increasingly becoming important company assets worthy of protection. Care should be taken to bind each manager and member with access to confidential information to hold that information for the benefit of the entity concerned so long as the person owns a membership interest and for a reasonable period of time thereafter.

V. **Other Operating Agreement Provisions.**

A. **Permitted Activities.** The members may wish to consider restricting the scope of permitted activities of the LLC without the consent of some specified number or percentage of the members.

B. **Alternative Dispute Resolution Provisions.** A mandatory arbitration or mediation provision is usually a good idea. If the members wish to have any sort of alternative dispute resolution procedure, such as arbitration, mediation or another process, that should be specified in the agreement. Typically, these provisions should not apply to a situation requiring injunctive relief.

C. **Dissolution.** The agreement should specify when and under what circumstances the LLC is to be dissolved. In Illinois, 805 ILCS 180/35-1 provides that an LLC will be dissolved as upon the happening of an event specified in the operating agreement, consent of the number or percentage of members specified in the operating agreement, an event that makes it unlawful to continue the LLCs business or by judicial order. Thus, it is important that the operating agreement be specific as to the events which will trigger dissolution. The agreement should also provide procedures for winding up the affairs of the company after dissolution, final distribution of assets to the members and filing of certificates and any other requirements with the appropriate state agency to officially dissolve the LLC.