

**Partnerships in the U.S.**  
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# Types of firms

- Corporation
- Close corporation (CC)
  - Subchapter S corporation (S Corp)
- Partnership
- Limited partnership (LP)
- Limited liability company (LLC)
- Limited liability partnership (LLP)
- Limited liability limited partnership (LLLP)

# General partnership

- For small and professional firms
- Simple structure: Owners equally share control, profits, losses and property.
- Each partner can dissolve and force liquidation of firm
- General partners are personally liable for business debts.
- No separate tax imposed on partnership entity

# Corporation

- Rules designed for larger firms
- No direct management by shareholders
- Shareholders not liable for corporate debts
- Individual shareholder cannot dissolve firm
- Advantages for start-up firms
  - Tax free reorganization for public offering
  - Classes of shares well-recognized, clear rules
  - Used for VC-financed: preferred shares for VC firm; no fiduciary duties; tax break on issuance of common shares
- Separate tax on corporate entity

# The problem

- How to combine partnership taxation and flexibility with limited liability?
- Possible solutions
  - Close corporation
  - Subchapter S corporation
  - Limited partnership and LLLP
  - LLP
  - LLC

# Close corporations

- Corporations allowed to adopt partnership management
- Problems
  - Management rules designed for larger firms
  - Owners had no right to dissolve and so might be stuck in firm and unable to sell shares
  - Judicial remedies dealt with this but were unpredictable

# Subchapter S corporation

- Partnership taxation for corporation
- Problems
  - Restricts structure: one class of stock
  - Limitations on owners

# Limited partnership

- Limited liability for passive limited partners
- Partnership taxation
- Contractual flexibility
- Useful for venture capital funds
- Problems
  - Limited partners liable if participate in management
    - Liability reduced in RULPA 1985 and eliminated in ULPA 2001
  - General partners liable for partnership debts
    - Exceptions: Corporate general partners, LLLPs
  - Partnership taxation not clear: classification rules
    - 1997: “check the box”

# Birth of the LLC

- Invented in Wyoming in 1977
- Based on LP but limited liability for all members and no member liability for managing
- Problems:
  - Might not be taxed as partnership
  - Rules initially unclear

# The rise of the LLC

- 1986 tax reform increased benefit of partnership taxation and use of partnership form
- Internal Revenue Service ruled in 1988 that a Wyoming LLC could be taxed as a partnership
- 1996: Every US jurisdiction had an LLC statute
- 1997: “Check the box” rule: LLCs and other non-corporations could be taxed as partnership
- LLC statutes revised, rules clearer
- LLCs are increasing against other business forms

## The limited liability partnership (LLP)

- State laws provided that general partnership could become LLP by making a filing
- LLP is “partnership” with limited liability,
- Used by professional firms that want or need to be “partnerships”

# General considerations

- Contractual nature of partnership
- Role of competition between states
- Firms may choose between business forms
- Effect of non-partnership law
  - Income tax depends on form of business
  - Estate and gift tax: elimination of buyout rights
  - Bankruptcy: effect on dissolution and withdrawal; priority of partners' creditors

# Comparison of business forms

- Tables show general rules; states may vary
- Uniform laws not adopted in every state
- Most rights subject to contrary agreement

# Session 2: Owner liability (4,8,9,12)

|             |  |
|-------------|--|
| Corporation | None   |
| CC          | Same as corporation  |
| Partnership | <ul style="list-style-type: none"><li>• Partners liable for debts</li><li>• New partners not liable for old debts</li><li>• Creditors must exhaust remedies against firm</li></ul> |
| LP          | <ul style="list-style-type: none"><li>• General partners liable</li><li>• Limited partners liable if manage (RULPA)</li><li>• Limited partners not liable (ULPA 2001)</li></ul>    |
| LLC         | Same as corporation  |
| LLP         | <ul style="list-style-type: none"><li>• May be liable if supervise or for firm's contracts</li><li>• Insurance requirement in some states</li></ul>                                |
| LLLP        | <ul style="list-style-type: none"><li>• Same as LLP for general partners</li><li>• Same as corporation for limited partners</li></ul>  |

# Creditor protections: veil-piercing

- Owners liable for abuse of creditors
  - Shuffling funds between owner and entity, or between entities
  - Misrepresentation of assets to creditors
- Corporate veil-piercing may not apply to LLCs
  - Formalities
  - Capitalization
- “Series” LLC protects related businesses
- “Reverse” limited liability: person with potential liability transfers assets to LLC
- “Reverse” veil piercing: court holds LLC liable

# Other creditor protections

- Contracts: member guarantee or firm waives limited liability
- Owner's liability for his own conduct
- Disclosure requirements; formalities of formation
- Capital requirements
  - Minimum capitalization
  - Restrictions on return of capital and compromise of contributions
  - But do creditors rely on capital or contributions?
- Distribution restrictions: statutory and fraudulent conveyance
- Insurance requirements
  - D & O: insures against misconduct of directors or partners
  - Professional firms: LLP requirements
  - No insurance for intentional misconduct or general business risk
  - Questions about type or amount of coverage

# Session 3: Contributions (1, 5)

|             |  |
|-------------|--|
| Corporation | <ul style="list-style-type: none"><li>• Property belongs to firm</li><li>• Title transfer to bind third parties</li><li>• Enforced by breach of contract</li></ul> |
| CC          | Same as corporation  |
| Partnership | Same as corporation, except rules for determining when property has been contributed to firm   |
| LP          | Same as corporation, except rules for compromise of contribution obligation  |
| LLC         | Same as LP   |
| LLP         | Same as partnership  |
| LLLLP       | <ul style="list-style-type: none"><li>• Same as LP for limited partners</li><li>• Same as LLP for general partners</li></ul>                                       |

# Session 3: Distributions (6, 10)

|             |   |
|-------------|---|
| Corporation | <ul style="list-style-type: none"><li>• Distributions limited by assets, insolvency, capital</li><li>• Shareholders liable if knew of violation</li><li>• Directors may be liable, then sue shareholders</li><li>• Liability is very rare</li><li>• Fraudulent conveyance liability</li></ul> |
| CC          | Same as corporation   |
| Partnership | No limitations except fraudulent conveyance   |
| LP          | Similar to corporation  |
| LLC         | Similar to corporation  |
| LLP         | Same as partnership   |
| LLLP        | Same as LP  |

# Session 4: Transfer (3)

|             |  |
|-------------|--|
| Corporation | Shareholders transfer management and financial rights  |
| CC          | Agreements may restrict transfer   |
| Partnership | <ul style="list-style-type: none"><li>• Partners may transfer financial rights</li><li>• Transfer of management rights only if partners consent</li><li>• Partners' creditors receive only financial rights but may foreclose and obtain dissolution</li></ul> |
| LP          | Same as partnership, but creditor can't sue to dissolve  |
| LLC         | Same as LP   |
| LLP         | Same as partnership  |
| LLLP        | Same as LP   |

# Session 4: Withdrawal (7,11)

|             |  |
|-------------|--|
| Corporation | Shareholders have no right to buyout (distinguish withdrawal)  |
| CC          | Possible judicial buyout for oppression  |
| Partnership | <ul style="list-style-type: none"><li>• Partnership at will: partner may withdrawal, which causes dissolution</li><li>• Partnership for term: partner may withdraw and get paid, less damages; dissolution only on majority vote</li><li>• Partner liable for existing debts</li></ul> |
| LP          | <ul style="list-style-type: none"><li>• No buyout right</li><li>• Majority of general partners must approve dissolution</li><li>• General partner liability same as partnership</li></ul>  |
| LLC         | Same as LP in most states but no member liability  |
| LLP         | Same as partnership but no partner liability   |
| LLLLP       | Same as LP but no partner liability  |

# Session 5: Dissolution (13)

|             |   |
|-------------|---|
| Corporation | <ul style="list-style-type: none"><li>• Directors authorize, shareholders approve dissolution</li><li>• Procedure for known and unknown liabilities. Transferees or partnership assets may be liable</li></ul>  |
| CC          | Dissolution or buyout for oppression  |
| Partnership | <ul style="list-style-type: none"><li>• Partnership at will: any partner may compel dissolution and liquidation</li><li>• Partnership for unexpired term: partner may withdraw and pay damages; dissolution on majority vote</li><li>• Partners liable for existing debts</li></ul> |
| LP          | <ul style="list-style-type: none"><li>• Majority of general partners approve dissolution</li><li>• General partner liability same as partnership</li><li>• Corporate procedure for liabilities</li></ul>  |
| LLC         | Same as LP in most states; no member liability  |
| LLP         | Same as partnership but no partner liability  |
| LLLP        | Same as LP but no partner liability   |

# Management and control

|             |  |
|-------------|--|
| Corporation | <ul style="list-style-type: none"><li>• Management by board; no special qualifications</li><li>• Shareholders vote by contribution, majority rule</li></ul>                              |
| CC          | <ul style="list-style-type: none"><li>• Default rules same as corporation</li><li>• Statutes permit variation of default rules</li></ul>   |
| Partnership | <ul style="list-style-type: none"><li>• Partners manage directly</li><li>• Equal vote and unanimity rule</li></ul>   |
| LP          | <ul style="list-style-type: none"><li>• General partners manage, vote by contribution</li><li>• No special qualifications</li><li>• Limited partners approve certain decisions</li></ul> |
| LLC         | <ul style="list-style-type: none"><li>• If member-managed: like partnership</li><li>• If manager-managed: like LP, but no liability for participating in management</li></ul>            |
| LLP         | Same as partnership  |
| LLLP        | Same as LP   |

# Fiduciary duties

|             |  |
|-------------|--|
| Corporation | <ul style="list-style-type: none"><li>• Directors owe fiduciary duties (loyalty, care, good faith) to corporation and, possibly, shareholders</li><li>• Shareholders do not owe fiduciary duties</li></ul> |
| CC          | Same as corporation, except shareholders owe duties if they manage instead of directors  |
| Partnership | <ul style="list-style-type: none"><li>• Partners owe duties to partnership and partners</li><li>• Limited waiver right (RUPA)</li></ul>  |
| LP          | <ul style="list-style-type: none"><li>• General partners: same as partnership</li><li>• Limited partners: fiduciary duties if they manage</li></ul>  |
| LLC         | <ul style="list-style-type: none"><li>• Managers are like general partners in LP</li><li>• Non-managing members: like limited partners</li></ul>   |
| LLP         | Same as partnership  |
| LLLP        | Same as LP   |

# Enforcement of duties

|             |   |
|-------------|---|
| Corporation | <ul style="list-style-type: none"><li>• Derivative suit for damage to corporation</li><li>• Direct suit for damage to individual members</li></ul>                          |
| CC          | Same as corporation, except possibly direct suit for damage to corporation  |
| Partnership | <ul style="list-style-type: none"><li>• Partnership suit for damage to partnership</li><li>• Direct suit for damage to owners</li><li>• Accounting required (UPA)</li></ul> |
| LP          | <ul style="list-style-type: none"><li>• Same as corporation</li><li>• Some states: same as partnership</li></ul>  |
| LLC         | <ul style="list-style-type: none"><li>• Most states: same as LP</li></ul>   |
| LLP         | Same as partnership   |
| LLLP        | Same as limited partnership   |