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Asset Protection and Entity Creation:
The Illinois LLC - - Defective for Asset Protection Purposes
By: Joseph D. Welch, Attorney at Law

Many clients want or need to create a business entity or an entity to hold investment assets which provides liability protections from predators. Traditionally this meant establishing a corporation, but corporations present both taxation and asset protection problems.

The Corporation. Corporations present a taxation problem, since income to the corporation is taxed at the corporate level, and then dividend distributions to the shareholders are taxed at the individual level. Some corporations can solve this problem by making an S-corporation election, which converts the corporation to a pass-through entity. However, corporations still provide only partial liability protection, since a judgment creditor can seize the corporate stock of the owner and vote the stock, even voting to liquidate the corporation to pay the creditor!

The Limited Partnership. Because of the number of business failures arising out of the Great Depression, an alternative form of business was created by statute: the limited partnership. The limited partnership provides for two classes of owners: a general partner and one or more limited partners. The limited partners are liable only to the extent of the amount of their investment in the company. The general partner, however, has unlimited liability. Because of this, it is usually thought necessary to establish a *second* entity to serve as the general partner, which is usually a corporation or a limited liability company created to provide asset protection for the general partner.

Creation of a second entity, however, results in a higher level of complexity. Not only must you create two entities, perform the accounting for two entities, file for tax i.d. numbers for two entities, prepare tax returns for two entities, make Secretary of State filings for two entities, and maintain bank accounts for two entities, but employment agreements and other contracts have to be prepared between two, and sometimes among three or more, entities! Because of the level of complexity, most people grow to hate their limited partnerships and end up wondering why they established them in the first place.

In addition, valuation discounting (previously thought to be freely available to limited partnerships) is now under serious attack by the IRS. The result is that many existing limited partnerships, which were done without excellent appraisals and ongoing maintenance assistance by professionals, may not survive audit by the IRS.

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The LLC. Limited liability companies (LLCs) are a hybrid between the corporation and partnership forms of doing business. They offer a flexible range of taxation options which are available merely by checking a box, so that the LLC can choose to be taxed as a “C” corporation, an “S” corporation, a partnership, or a sole proprietorship for income tax purposes. LLCs have only one class of interest, and the LLC manager is not required to be a business owner.

The result is that complexity and costs are minimized -- you create and maintain only one entity, which means that you have only one tax i.d. number, one tax return, accounting for only one entity, and state filings, bank accounts and contracts for only one entity.

The Charging Order. Liability protection of limited partnerships and LLCs is provided by creation of a special type of lien called a "charging order." The charging order was designed to solve the problem of business failures during the Great Depression, resulting from creditors of the business seizing control and liquidating the business. The charging order lien is designed to prevent creditors from seizing the assets of the entity. However, in Illinois, *creditors can foreclose the charging order!* This makes the “limited liability” feature of Illinois limited partnerships and Illinois LLCs a nullity, since **the Illinois statute specifically provides that the charging order can be foreclosed through sale** (See attached comparison of Illinois and Missouri LLC statutes). Only seven other states in the union have stripped their LLCs of asset protection by allowing statutory foreclosure of the charging order, as Illinois has done.

The Bottom Line. Never set up an Illinois limited partnership, Illinois family limited partnership, or Illinois LLC, since they all share this same defect, allowing the creditor to foreclose the charging order!

The Silver Lining. Illinois residents interested in real asset protection can avail themselves of the law of more protective jurisdictions, since Illinois law allows you to "choose the law" which governs liability of the LLC members. Illinois statute provides as follows:

The laws of the State...under which a foreign limited liability company is organized govern...the liability of its managers, members, and their transferees. (805 ILCS 180/45-1).

Missouri law does **not** allow a judgment creditor to own the debtor's LLC interest and does **not** provide for foreclosure of the charging order. In addition, other states provide that the charging order is the "sole remedy" available to creditors. These states include: Alabama, Alaska, Arizona, Delaware, Kansas, Minnesota, Nevada, New Jersey, North Carolina, North Dakota, Oklahoma, Tennessee and Wyoming.

Planning Opportunities. "Shop" for the most advantageous law for your protection. Avoid ineffective local “solutions.” Choose the law of the **best** state in which to establish your entities to operate businesses or to hold investment assets.

Pursuant to U.S. Treasury Department Regulations, I am now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and may not be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

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The Canons of Ethics prohibit attorneys from soliciting clients. You will need to contact me if you would like to speak to me regarding estate planning or asset protection issues.

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ILLINOIS STATUTE PROVIDES FOR CHARGING ORDER AND THEN ALLOWS FORECLOSURE:

(805 ILCS 215/703)

Sec. 703. **Rights of creditor** of partner or transferee.

(a) On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the transferable interest of the judgment debtor with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of a transferee. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the partnership and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances of the case may require to give effect to the charging order.

(b) A charging order constitutes a lien on the judgment debtor's transferable interest. **The court may order a foreclosure upon the interest subject to the charging order at any time.** The purchaser at the foreclosure sale has the rights of a transferee.

(c) At any time before foreclosure, an interest charged may be redeemed:

(1) by the judgment debtor;

(2) with property other than limited partnership property, by one or more of the other partners; or

(3) with limited partnership property, by the limited partnership with the consent of all partners whose interests are not so charged.

(d) This Act does not deprive any partner or transferee of the benefit of any exemption laws applicable to the partner's or transferee's transferable interest.

(e) This Section provides the exclusive remedy by which a judgment creditor of a partner or transferee may satisfy a judgment out of the judgment debtor's transferable interest.

(Source: P.A. 93-967, eff. 1-1-05.)

ILLINOIS STATUTE ALLOWS YOU TO CHOOSE WHICH LAW APPLIES:

(805 ILCS 180/45-1)

Sec. 45-1. Law governing foreign limited liability companies.

(a) The laws of the State or other jurisdiction under which a foreign limited liability company is organized govern its organization and internal affairs and the liability of its managers, members, and their transferees.

(b) A foreign limited liability company may not be denied admission by reason of any difference between the laws of another jurisdiction under which the foreign company is organized and the laws of this State.

(c) Having authority to transact business in this State does not authorize a foreign limited liability company to engage in any business or exercise any power that a limited liability company may not engage in or exercise in this State.

(Source: P.A. 93-59, eff. 7-1-03.)

MISSOURI LLC STATUTE PROVIDES FOR CHARGING ORDER ONLY:

Judgment creditor of member, charge of member's interest with payment of unsatisfied judgment.

347.119. On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's interest in the limited liability company with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the member's interest. Sections 347.010 to 347.187 do not deprive any member of the benefit of any exemption laws applicable to his interest in the limited liability company.

(L. 1993 S.B. 66 & 20 § 359.774)
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