ProNet Practice Notes

Limited Liability Partnerships and Limited Liability Companies

Are these the entities of choice for a/e firms in the next millennium?

INTRODUCTION

In reaction to the litigious climate and the runaway jury verdicts of today, architects and engineers have been forced to engage in a variety of risk management and risk avoidance tools and techniques. Today's loss prevention strategies include defensive project management, use of peer review, rigorous review of contracts by in-house or outside legal counsel, avoidance of certain types of projects and/or clients, and in some cases, reorganization of the firm into a limited liability entity such as a corporation, limited liability partnership (LLP) or limited liability company (LLC).

In this issue of ProNet Practice Notes, we will examine the significant features of LLPs and LLCs, their advantages and disadvantages for a/e's as compared to other business formats such as corporations or general partnerships, and the general requirements for the formation of an LLP or LLC.

HISTORICAL BACKGROUND

In the early days of practice, architects and engineers could choose from only two business formats. If the firm was owned by one person, it was a sole proprietorship. If the firm was owned by two or more persons, it was a general partnership. In both formats, each owner bore unlimited personal liability for all of the firm's debts, liabilities, and obligations.

Beginning in the 1960s, and fueled by the desire to limit their personal liability (as many of their clients had by forming development corporations), architects and engineers began lobbying for legislation allowing them to form corporations. Initially, these efforts met with great resistance. The public's sentiment at the time was that architects and engineers were professionals, and thus, should not be permitted to limit their personal responsibility at the expense of the public's health and safety.

While architects and engineers were ultimately successful in passing legislation allowing them to incorporate, many found the corporate format cumbersome. For many, the burdens of double taxation (once at the corporate level as fees are collected from clients, and again, at the shareholder level when profits are distributed) and adherence to corporate formalities, such as the requirements to hold shareholder meetings and maintain minutes, outweighed the benefit of limited liability offered by the corporate format.

It was in response to this dissatisfaction with existing formats that LLPs and LLCs came into being. LLCs and LLPs are a hybrid of corporations and general partnerships, offering their owners limited liability without double taxation and the formalities generally required of a corporation. (In most states, LLPs and LLCs are virtually identical with regard to their taxation, the manner in which they are managed, and the liability of their owners. Commonly, either one form or the other is available to professionals, and that form will require the professional to post some form of security against potential claims or maintain minimum levels of professional liability insurance coverage.)

LLPs and LLCs are not, however, uniformly available to architects and engineers in all states. In some states, architects and engineers can form LLPs, but not LLCs. In other states, only the LLC format is available, or one format is available to architects, but not to engineers, or vice versa. A handful of states offer neither LLPs nor LLCs to its architects and engineers. For specific information about the LLP or LLC law in a particular state, the reader should consult the specific statutes of that state.

THE ADVANTAGES OF LLCs AND LLPs

Limited Liability

For most architects and engineers, the single most enticing attribute of an LLP or LLC is its limited liability. Every state's LLP or LLC legislation provides some form of limited liability for the entity's partners or members. In some states, the limitation of liability goes as far as protecting the partners' or members' personal assets, e.g., cars, homes, stocks and bonds, etc., against a wide range of business losses, including losses resulting from errors and omissions or other tortious conduct of an employee, co-partner or co-member. In no state, however, may an architect or engineer, or any other professional for that matter, escape personal liability for his or her own tortious conduct or certain IRS tax liabilities. In the context of project liability, an architect or engineer will always be liable for his or her personal errors and omissions, i.e., his or her direct negligence.[1] This means an architect or engineer who has signed a drawing will be directly liable for any errors or omissions in the work product reflected by the drawing. (Under most states' practice acts, a licensed architect or engineer is required to undertake a specific level of review before signing drawings which he has not personally prepared.) Similarly, to the extent an architect or engineer is in "responsible charge " of a subordinate, his negligent supervision of that subordinate could also lead to personal liability.

The precise extent of limited liability varies state to state. Depending on when the state's statute was enacted, LLP and LLC laws tend to fall into three broad categories.

In the earliest group of states enacting LLP or LLC legislation, the extent of personal protection is rather limited. In these states, which include Texas, Delaware and the District of Columbia, LLP partners or LLC members can insulate themselves from tort liability arising out of the professional errors and omissions of their employees and fellow partners or members, but remain liable for their own tortious conduct. (In legal parlance, the former is known as vicarious liability.) However, under these early state statutes, partners and members also remain personally at risk for liability outside of their professional practice, e.g., sexual harassment claims, as well as commercial and contractual based claims such as claims for breach of lease, non-payment to a consultant or vendor, and defaults under banking or lending agreements. As these statutes are written, personal liability in the professional liability context would extend to each and every partner or member-- even if the alleged error or omission was caused by another partner, member or employee of the firm-- as long as the claim was framed as a breach of contract action based on the owner/architect or owner/engineer contract.

In a second and later enacted group of states' statutes, partners and members are protected against all vicarious professional liability, whether the claim is based in negligence or in contract. Like the earlier statutes, however, personal liability in these states remains for a partner's or member's own direct negligence, as well as for tort and contract claims outside of the professional liability context.

In the last group of states to enact LLP or LLC legislation, including California, partners and members receive the broadest protection of all. In these states, LLP partners and/or LLC members bear personal liability only for their own direct tortious conduct and contractual or commercial liabilities which they have personally guaranteed. Thus, absent direct personal involvement or a personal guarantee, liability to third parties in these states is limited to the assets of the LLP or LLC entity.

Flexible Management Structure

Another advantage of the LLP or LLC structure is the flexibility afforded to the entity through its management structure. With the exception of statutory close corporations, all corporations must utilize a formal and centralized management structure. A corporation's shareholders elect the board of directors, who in turn, are responsible for the overall management of the corporation. The board of directors then appoints officers to attend to the corporation's day-to-day business needs. Shareholders do not participate in the day-to-day management of the corporation's business unless they concurrently hold office or sit on the board of directors. In a smaller corporation, a shareholder will typically serve as both a director and officer, and that individual must be vigilant in identifying the "hat " he or she is wearing when acting on the corporation's behalf.

LLPs and LLCs, like general partnerships, may choose a centralized management structure akin to a corporation, (e.g., appointment of an executive committee), or it may be completely decentralized, with every partner or member participating in the management of the entity's business affairs.

No Corporate Formalities

Consistent with the flexible management options they offer, LLPs and LLCs do not have to observe the corporate formalities normally imposed upon corporations. Shareholders of a corporation are required to hold annual meetings, formally elect board members for fixed terms, and maintain minutes of all of its meetings. Board action must be reflected in written meeting minutes or authorized by written resolutions. Unless it is a statutory close corporation, failure of a corporation to observe such formalities will allow corporate creditors to "pierce the corporate veil " and attack the personal assets of the shareholders. LLP partners and LLC members, by contrast, are not required to observe such corporate formalities.

Pass-Through Tax Treatment

Yet another significant advantage of an LLP or LLC is its "pass-through " tax treatment. In an LLP or LLC, income is passed through to its partners or members and taxed at the individual partner or member level. No income tax is assessed at the entity level. Corporations, by contrast, are taxed once on their income at the entity level when its revenues are generated (accrual basis taxpayers) or collected (cash basis taxpayers), and then its shareholders are taxed a second time, at the individual level, when the income is distributed as dividends or salaries.

A corporation may avoid the double level of taxation by making an election under Subchapter S of the Internal Revenue Code ("S Corp "), or matching expenses to income and "zeroing out " profits at the end of each fiscal year, as many firms do. These tax minimization strategies may, however, produce undesirable consequences. To maintain its eligibility to be an S corporation, the corporation cannot have more than seventy-five shareholders, cannot have more than one class of stock, (i.e, no preferred shares), and all shareholders must be natural persons, (i.e., no subsidiaries). Furthermore, S corporations are not allowed to deduct the full cost of health insurance and other expense items paid on behalf of shareholders owning two percent or more of the shares. The zeroing out strategy typically entails payment of large bonuses to principals at year's end. However, if the total compensation paid to the shareholders is too high when compared to colleagues in comparable firms, or if bonuses are too closely proportionate to equity ownership, the IRS might treat a portion of the shareholders' compensation as disguised dividends and assess both interest and penalties. With the pass-through tax treatment of an LLP or LLC's income, such maneuvers are unnecessary.

Flexible Capital Structure

An LLP or LLC also provides its owners with flexibility in setting up a capital and compensation structure. Corporations are capitalized with investments of capital by its shareholders, who receive shares of stock in exchange for their capital contributions. Under a strict application of corporate principles, distributions of profit to shareholders (in the form of dividends) must be in proportion to their ownership of shares. Disproportionate distributions characterized as salary or bonuses are an option, but they leave the corporation vulnerable to unreasonable compensation and disguised dividend arguments from the IRS.

LLP partners or LLC members, on the other hand, may distribute profits in any manner they want without regard to each partner's or member's capital contribution. While LLP or LLC profits may be distributed on the basis of capital account balances, profits may also be distributed on the basis of a principal's seniority, hours billed, volume of business brought in by each partner or member, or any other factor the partners or members wish to consider.

DISADVANTAGES OF AN LLP OR LLC

While an LLP or LLC structure provides many advantages, an architect or engineer must also consider potential disadvantages of these structures.

Restrictions on Ownership

For many architects and engineers, a significant disadvantage of the LLP or LLC format is its restriction on ownership. Absent a restriction imposed by a state's professional practice act, an architect or engineer is free to form a general partnership with anyone -- even if he or she is not licensed in the same profession. Ownership in an LLP or LLC, on the other hand, is generally limited to licensed professionals within the same discipline. Thus, an architect or engineer utilizing an LLP or LLC structure may not bring in a business manager, financial manager, or financial investor as a co-owner unless that person also holds an architectural or engineering license. Furthermore, absent a specific statutory exception, an LLP or LLC cannot be inter-disciplinarily owned, i.e., all owners must be licensed or registered architects, or all owners must be licensed or registered engineers.

Franchise Taxes and Minimum Security

Most states impose a monetary cost for the privilege of doing business as an LLP or LLC. These costs usually entail an annual franchise tax, and/or a tax on gross receipts. Furthermore, in the interest of protecting the public welfare and to mitigate the public's concern about limiting liability, most states also impose minimum security requirements as a condition to limited liability, or impose personal liability on the owners up to the amount of the required security if there is a shortfall. The purpose of the security is to guarantee an available fund or pool of assets to respond to errors and omissions claims. Generally, the security must be maintained at all times during which the LLP or LLC transacts business.[2] In some states, the security must stay in place for a period of time even after the entity is dissolved.

Liability for Improper Distributions

Consistent with the public policy concerns which led to the adoption of minimum security requirements, many states allow for the disgorgement or forfeiture of an LLP's or LLC's improper distributions to its owners and impose personal liability on partners or members who approve a distribution to its owners despite the entity's insolvency. Distributions include disbursements of profit, as well as payments to former partners and members in liquidation of their LLP or LLC interests. Because of similar limited liability afforded to shareholders of a corporation, corporations are subject to similar restrictions, while general partners are not.

Minimum Number of Owners

Another potential disadvantage of an LLP or LLC is that in most states there must be at least two equity owners. Thus, while a sole owner can incorporate, he cannot form an LLP or LLC. Two-owner firms may also find LLPs or LLCs problematic: Surviving partners or members would be forced to dissolve the entity upon the death or incapacity of the other partner or member. This can be costly tax-wise, and create a host of logistical hassles.

Interests Not As Freely Transferable

In theory, LLP and LLC interests are not as freely transferable as are shares of a corporation's stock. In some older states' LLP statutes, an LLP is considered another form of partnership. Viewing partnerships as a consensual relationship among partners, such statutes provide that any change in the composition of the partners--even the addition or withdrawal of one partner--will cause a dissolution of the entity. Under corporate law, shares are freely transferable absent an agreement providing otherwise, e.g., a buy-sell agreement.

LLPs and LLCs Not Available in All States

As we have mentioned, LLPs and LLCs are not uniformly available to architects and engineers in all states. For a firm with a multi-state practice, this can expose the partners or members to unwanted personal liability. If the LLP or LLC structure is not available to architects or engineers in a particular state, an out of state architectural or engineering LLP or LLC with an office in the non-LLP or LLC state will probably be treated as a defacto general partnership. In the non-LLP or LLC state, this would render the partners or members jointly and severally liable for all of the entity's activities.

Limited Merger Opportunities

Finally, given the new and untested history of the LLP and LLC structures, states are only now beginning to amend their statutes to allow LLPs or LLCs to merge with other types of entities. This may cause the partners or members to lose out on tax free merger and reorganization opportunities.

ADVANTAGES OF A CORPORATION

From a liability standpoint, the corporate business form in most states is comparable to an LLP or LLC. Like an LLP or LLC, corporations insulate the shareholders from personal liability for the debts, liabilities and obligations of the entity. Unlike an LLP or LLC, however, most states do not impose a gross receipts tax on corporations. Nor do most states require an architectural or engineering corporation to maintain insurance or other security.

Because the corporation has been available for some time in most states, a corporation can easily qualify to do business in other states as a foreign corporation. Corporations can also merge freely with other corporations and enter into tax free reorganizations. Moreover, because a corporation allows for as little as only one owner, a corporation provides greater continuity of existence for two- owner firms than an LLP or LLC.

DISADVANTAGES OF A CORPORATION

In some states, shareholder liability is not quite on par with LLP partner or LLC member liability, giving LLPs and LLCs a slight advantage over a corporation in those states. For example, in California the LLP statute clearly delineates the scope of a partner's personal liability. California's statute explicitly provides, in pertinent part, "...a partner in a registered limited liability partnership is not liable... for debts, obligations or liabilities of or chargeable to the partnership or another partner... that are incurred... by reason of being a partner or acting in the conduct of the business or activities of the partnership. "

(Cal.Corp. C. Section 16306.) Comparable provisions are not found in either California's professional corporation statute or general corporation law. Thus, in California, LLP partners have greater certainty with respect to the extent of their personal liability than do their corporate-shareholder counterparts.

While limited liability provides a huge incentive for an architect or engineer to incorporate, the management and maintenance of a corporation can often be costly and time consuming. This is particularly so for a small firm in which the professionals procure clients and execute the projects, as well as manage the business, personnel, and administrative issues. Corporations require a formal and centralized management structure, annual meetings, and written resolutions. Corporations also provide little flexibility in its capital and compensation structures, and are potentially subject to two levels of taxation.

Finally, in states where architects and engineers are permitted to form only professional corporations (as opposed to general corporations), ownership, board seats and officer positions will, like an LLP or LLC, be restricted to professionals licensed in the same discipline.

ADVANTAGES OF A GENERAL PARTNERSHIP

The general partnership is another business format available to architects and engineers. Of all the business formats discussed here, general partnerships have been around the longest.

A general partnership shares with LLPs and LLCs the attributes of flexibility of management styles, flexibility of capital and contribution structures, pass through tax treatment (single level taxation) and lack of corporate formalities. Indeed, under most state laws, no written partnership agreement is even required. (Under the broad definition of a general partnership in some state statutes, this has proven to be a trap for the unwary. In these states, two or more individuals may be deemed general partners merely by manifesting an intent to jointly carry on a business or venture for a profit.) In contrast, a corporation must have articles and bylaws, and an LLP or LLC must register with the state and in almost all states must have either a written partnership or operating agreement.

Absent a prohibition in the state's professional practice act, an architect or engineer is free to become general partners with anyone he or she pleases. Furthermore, most states do not require architects and engineers to maintain insurance or other security against professional liability claims.

DISADVANTAGES OF A GENERAL PARTNERSHIP

The biggest disadvantage of a general partnership is its lack of liability protection for its individual owners. Under the general partnership law of most states, each and every partner is jointly and severally liable for all of the partnership's debts, liabilities and obligations. Thus, even if a partner was not involved in a project, his personal assets would still be at risk to pay damages arising from errors and omissions occurring in connection with that project. Worse yet, under joint and several liability principles, an injured plaintiff could choose to sue only one of the partners and recover the entire judgment solely from that partner. Or, a plaintiff might sue all of the partners, but because one or more of the partners is financially insolvent or "judgment proof, " the solvent partners would be responsible for the entire amount of the judgment. Of course, the paying partners would have a right of reimbursement (on a pro rata basis) from the non-paying partners. If the nonpaying partners are insolvent, however, the paying partners would still

end up "holding the bag. " This is because a third party is generally not bound by the partners' internal agreement regarding the sharing of losses and liabilities.

As with an LLP or LLC, a general partnership must have at least two partners. For two-owner firms, this will present continuity problems should one of the partners die or become disabled. Additionally, given the age of most general partnership statutes, mergers and tax-free reorganizations with other types of entities are not available.

CONCLUSION

Choosing the right form of entity can be an effective risk management tool. Depending on how you run your firm, a limited liability entity such as a corporation, LLP or LLC can protect your hard earned assets from liability to third parties. If you, as a principal, are involved in each and every project within the office and sign all the drawings, you may not be able to take advantage of all the benefits of a limited liability entity. (See discussion above regarding direct liability.) Similarly, the owners of most small firms will no doubt be required to guarantee all of the entity's bank loans and leases. Under those circumstances, the extent of an owner's liability protection would be limited to commercial debts and obligations owed to consultants, and an owner must then ask him or herself whether this, and the other benefits of a limited liability entity, outweigh their costs.

In contrast, if projects within the firm are assigned and delegated among a group of principals or senior employees, the protection against vicarious liability may be a benefit which is too good to pass up. What if your firm is hit with a runaway verdict in excess of policy limits, or policy limits have been depleted by defense costs and payment of other claims? Faced with these kinds of "what ifs, " the comfort of limited liability may allow an owner to sleep better at night.

LLPs and LLCs combine the advantages of a general partnership vis-à-vis their management, operation, and taxation, yet provide limited liability to their owners-- the single most advantageous feature of a corporation. It is no surprise, then, that LLPs and LLCs are quickly becoming the entity of choice for architects and engineers as we approach the next millennium.

CHECKLIST FOR ANALYZING THE PROS AND CONS OF CONVERSION TO AN LLP OR LLC

Is conversion to an LLP or LLC right for your firm? The following are questions that will help you analyze whether such a move is appropriate or even feasible. After determining that such a conversion would be worthwhile, you should, of course, discuss these issues in further detail with competent legal counsel.

1. What is the firm's current form of business? Is it a sole proprietorship, general partnership or a corporation?
2. Will the laws of the state of the firm's principal place of business allow the existing sole proprietorship, general partnership, or corporation to "convert " to an LLP or LLC, i.e., is the format available to architects, engineers, or multi-discipline firms? Will it allow the existing entity to convert without having to dissolve and terminate the existing entity? (If the existing entity must be terminated, conversion may trigger significant tax consequences, and require the entity to obtain new employer identification numbers, business licenses, etc.)
3. What do the laws of the state of the firm's principal place of business provide regarding the scope of an owner's personal liability?
4. How many principals and employees are there currently? (Most states require LLPs and LLCs to have at least two equity owners.)
5. How are project responsibilities allocated among the principals and employees? Who signs the drawings? (If all principals are involved in every project, an LLP or LLC may provide little opportunity to limit the principals' professional liability.)
6. How much liability insurance does the firm currently carry? Are there any significant coverage exclusions? Is the firm prepared to carry the minimum amount of insurance coverage or maintain other security as required by the state's LLP or LLC statute?
7. How is the firm currently taxed? How will conversion affect the firm's tax status? For example, will LLP or LLC status cause the firm to lose the ability to choose a fiscal year end other than December 31? Are the principals prepared to manage personal obligations in lieu of withholdings? Will any deductions, such as those for medical insurance premiums, go away?
8. Does the state in which the firm is principally located impose any special taxes or fees on LLPs or LLCs?
9. Are there any merger plans on the horizon? If so, do the laws of the firm's home state allow LLPs or LLCs to merge with other types of entities?
10. How much business does the firm do out of state? Does the firm have offices in other states? Do the laws of the other states require and/or allow "foreign " LLPs or LLCs to qualify to do business in their state? If so, what are the requirements and cost for doing so?
11. Determine the effect of conversion on pension plans, etc.
12. Is there likely to be a vote of majority in interest required (or different vote as specified in the firm's current partnership agreement or specific state statute) to approve conversion to LLP or LLC status?

Footnotes:

1. However, labor codes in most states require an employer to defend claims against its employees where such claims are alleged to arise from or during the employee's discharge of his or her duties to the employer. By definition, this would include shareholder-employees of a corporation. Moreover, virtually all liability insurance policies issued to an entity will include coverage for the employees' acts undertaken on the entity's behalf.
2. For example, California requires an architectural LLP to maintain professional liability insurance in an amount equal to $100,000 per claim, multiplied by the number of licensed architects (not just partners) rendering professional services on the LLP's behalf, up to a maximum of $5 million, but in no event less than $500,000. Alternatively, the LLP may maintain liquid assets in the form of a cash account, trust, bank escrow, certificate of deposit, treasury bill, or any combination thereof, or submit a written statement on an annual basis certifying that its net worth equalled or exceeded $10 million as of the most recently completed fiscal year.

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