LLCs vs. LLPs: Understanding the Differences, Liability Protection, and Importance of Proper Planning



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One of the most important decisions facing real estate investors, developers, and business owners is how to structure ownership of their assets and operations. The choice of business entity can have significant consequences for personal liability, taxation, management, asset protection, and the ability to transfer ownership interests. Two commonly used business structures are the limited liability company (LLC) and the limited liability partnership (LLP). Although both provide important liability protections and considerable flexibility, they were developed for different purposes and have distinct legal characteristics.

This edition of *This Month in Real Estate* examines the history of LLCs and LLPs, their similarities and differences, the protections they provide, and the importance of properly drafted operating and partnership agreements.

The Evolution of the Limited Liability Partnership

Historically, individuals conducting business through a general partnership faced substantial personal liability. Generally, partners could be held personally responsible for partnership obligations, including liabilities arising from the actions of other partners. The LLP emerged as a means of addressing this exposure.

Texas enacted the first LLP statute in 1991, primarily to protect partners in professional firms, particularly law and accounting firms, from personal liability arising from the negligence of other partners. Other jurisdictions quickly followed. Delaware adopted LLP legislation in 1993, expanding the protections available to partners. During the following years, states increasingly adopted broader liability shields covering both tort and contractual obligations.

Today, LLP statutes generally protect partners from personal liability for partnership obligations solely because of their status as partners. However, those protections do not necessarily insulate partners from liability arising from their own misconduct or obligations they personally assume.

The Development of the Limited Liability Company

The LLC developed along a different path. Wyoming enacted the first LLC statute in 1977, followed by Florida in 1982. The objective was to combine two characteristics that historically had been difficult to obtain within a single business structure: the limited liability associated with corporations and the federal income tax treatment generally available to partnerships.

Initially, uncertainty concerning federal tax classification discouraged widespread use of LLCs. That uncertainty was substantially reduced in 1988, when the Internal Revenue Service issued Revenue Ruling 88-76, recognizing that an

appropriately structured LLC could qualify for partnership taxation notwithstanding the limited liability afforded to its members.

By 1996, all 50 states and the District of Columbia had enacted LLC statutes. Another significant development occurred in 1997, when the federal check-the-box regulations became effective. These regulations simplified federal tax classification and generally permitted multi-member LLCs to be treated as partnerships and single-member LLCs to be treated as disregarded entities, unless an available alternative classification was elected. These developments helped establish the LLC as one of the most widely used business structures in the United States.

LLCs and LLPs: Understanding the Differences

Although LLCs and LLPs share several characteristics, there are important distinctions.

Ownership
An LLC may have one member or multiple members. An LLP generally requires at least two partners. For real estate investors, this is particularly important. This allows an individual or entity to hold property through a separate legal entity without requiring an additional owner.

Legal Status
Both structures are recognized under applicable law and may own real estate, enter contracts, incur obligations, and conduct business in their own names.

Management
An LLP is generally managed by its partners, subject to its partnership agreement. An LLC may be managed by its members or by designated managers, providing greater flexibility in separating ownership from day-to-day management.

Formation
An LLC is formed through the filing of a certificate of formation or comparable organizational document. An LLP generally obtains its limited liability status by filing a statement of qualification or registration under applicable state law.

Taxation
LLPs generally are taxed as partnerships for federal income tax purposes. Multi-member LLCs also are taxed as partnerships by default, while single-member LLCs generally are disregarded as separate entities from their owners for federal income tax purposes. Unlike LLPs, LLCs may have a single owner and may elect to be taxed as corporations, including S corporations if applicable eligibility requirements are satisfied.

Business Activities
LLCs generally may engage in any lawful business activity, subject to applicable restrictions. Some jurisdictions restrict the types of businesses that may operate as LLPs.

The Liability Shield: What Does It Actually Protect?

Perhaps the most important feature of both LLCs and LLPs is the statutory liability shield. Under Section 18-303(a) of the Delaware Limited Liability Company Act, the debts, obligations, and liabilities of an LLC, whether arising in contract, tort, or otherwise, are generally obligations of the company itself. A member or manager is not personally liable for those obligations solely because of being a member or acting as a manager. Similarly, Section 15-306(c) of the Delaware Revised Uniform Partnership Act generally provides that obligations arising while a partnership has LLP status are obligations of the partnership, and partners are not personally liable solely because of their status as partners.

These protections are particularly important in real estate transactions. For example, an investor who acquires commercial property through an LLC may be able to separate liabilities associated with that property from the investor's personal assets. However, limited liability does not mean the complete elimination of personal exposure. Members, managers, and partners may remain personally liable for their own wrongful conduct, personal guarantees, or other obligations they expressly

undertake. Under appropriate circumstances, courts may also impose liability under applicable veil-piercing or related legal doctrines.

Delaware law expressly recognizes that an LLC member or manager may agree to personal liability under Section 18-303(b). Section 15-306(e) provides a corresponding rule for LLP partners. Importantly, the liability shield protects the owners from certain obligations of the entity. It does not protect the entity's own assets from claims against the entity. Accordingly, appropriate liability insurance remains an essential component of an effective asset-protection strategy.

Asset Protection Beyond the Liability Shield

LLCs and LLPs may provide additional protections beyond shielding owners from entity liabilities. Three concepts are particularly important: liability shields, pick-your-partner protections, and charging orders.

Liability Shields - Liability shield provisions generally protect members and partners from personal responsibility for obligations incurred by their LLC or LLP solely because of their ownership status. As discussed above, these protections do not eliminate liability arising independently from personal misconduct, guarantees, or other legally recognized grounds.

Pick-Your-Partner Protections - Pick-your-partner provisions generally protect the ability of members and partners to control who participates in management of the business. For example, if a member of a multi-member LLC incurs a personal judgment, the judgment creditor does not automatically become a member with the right to participate in management or make business decisions. This protection can be especially important in real estate ventures involving multiple investors who have agreed to conduct business together.

Charging Order Protections - Charging-order provisions address the rights of a judgment creditor seeking to satisfy a personal judgment against an LLC member or partnership partner. Delaware provides particularly significant statutory protection in this area. Under 6 *Del. C*. § 18-703, a charging order is the exclusive remedy by which a judgment creditor may satisfy a judgment from a debtor's Delaware LLC interest. The statute expressly applies to both single-member and multi-member LLCs. Similarly, 6 *Del. C*. § 15-504 provides that a charging order is the exclusive remedy by which a judgment creditor may satisfy a judgment from a partner's economic interest in a Delaware partnership. Generally, the creditor is limited to distributions that otherwise would have been payable to the judgment debtor. The charging order does not, by itself, confer management rights or ownership of the entity's underlying property. These protections can be particularly important where several investors own real estate through a common entity and one investor experiences personal financial difficulties unrelated to the property. However, charging-order protections should not be confused with immunity from creditors. Their application depends on the nature of the claim, the entity, and the governing law.

Delaware's Emphasis on Freedom of Contract

One of the defining characteristics of Delaware's LLC statute is its emphasis on freedom of contract. Section 18-1101(b) of the Delaware Limited Liability Company Act expressly establishes a policy of giving maximum effect to freedom of contract and the enforceability of LLC agreements. This allows members considerable flexibility to establish their respective economic rights, management responsibilities, voting arrangements, and obligations through the operating agreement.

Delaware law also permits substantial modification of fiduciary duties. Under Section 18-1101(c), an LLC agreement may expand, restrict, or eliminate fiduciary duties that otherwise would apply to members, managers, or other covered persons. However, an LLC agreement may not eliminate the implied contractual covenant of good faith and fair dealing. Section 18-1101(e) also permits substantial contractual limitation or elimination of liability for breaches of contract and duties, subject to the statutory exception concerning bad-faith violations of the implied contractual covenant.

These provisions underscore the importance of carefully drafting the operating agreement. The parties' contractual arrangements may substantially determine their rights, duties, and remedies. Although LLPs also provide considerable contractual flexibility, the governing partnership statute and applicable limitations must be considered separately.

The Importance of Operating and Partnership Agreements

Forming an LLC or registering an LLP is only the beginning. The operating agreement or partnership agreement establishes the framework through which the entity will conduct business and governs the relationships among its owners. For real estate entities, particularly those with multiple investors, a properly drafted agreement should address at least ten important issues.

- Identification of Members or Partners **-** The agreement should identify the owners, their respective interests, and whether they hold those interests individually or through other entities or trusts.
- Purpose and Nature of the Business - The agreement should describe the nature of the business, including any contemplated real estate acquisitions, development, leasing, management, or investment activities.
- Capital Contributions and Economic Rights - The agreement should address initial and additional capital contributions, allocations of profits and losses, distributions, and the consequences of failing to make required contributions.
- Transfers of Ownership Interests - The agreement should establish restrictions on transfers, the admission of new members or partners, and the treatment of transfers resulting from death, bankruptcy, or other circumstances.
- Withdrawal and Dissociation - The agreement should specify the circumstances under which an owner may withdraw or cease participating in the entity and the economic and management consequences of that event.
- Management and Decision–Making - The agreement should establish who has authority to manage the entity, execute contracts, borrow money, acquire or sell real estate, and make other significant business decisions.
- Fiduciary Duties - The agreement should address the duties owed among owners and to the entity, including any modifications permitted by applicable law.
- Dissolution and Winding Up - The agreement should establish the events triggering dissolution and the procedures for liquidating assets, paying liabilities, and distributing remaining proceeds.
- Amendments and Other Contractual Provisions - The agreement should contain appropriate provisions concerning amendments, interpretation, notices, and the integration of the parties' agreement.
- Dispute Resolution - The agreement should establish procedures for resolving disputes, including the appropriate forum and any agreed mediation, arbitration, or judicial remedies.

These issues are not merely theoretical. Consider an LLC formed by three investors to acquire and develop commercial property. What happens if the project requires additional capital and one investor refuses to contribute? Can two members approve a sale over the objection of the third? What happens if a member dies, becomes disabled, or files for bankruptcy? Without a carefully drafted operating agreement, the answers may depend on statutory default provisions that do not reflect the parties' intentions.

Choosing the Appropriate Entity

There is no single entity structure appropriate for every real estate transaction. An individual purchasing a rental property may have different needs from a group of investors developing a commercial project. A family-owned real estate holding company may require different management and succession provisions from a professional services partnership. The analysis should consider liability protection, ownership structure, management flexibility, federal and state taxation, financing requirements, transfer restrictions, succession planning, and administrative costs.

Equally important is the distinction between forming an entity and properly operating it.

An LLC or LLP should be maintained in accordance with applicable law, its governing agreement, and the legitimate separation between the entity and its owners.

Final Thoughts

LLCs and LLPs have fundamentally changed the way individuals and businesses structure ownership and manage liability. Both offer important advantages, but neither should be viewed as a complete solution to every potential legal or financial risk. For real estate investors, developers, and business owners, the objective is not simply to form an entity. It is to establish a legal structure that protects legitimate interests, clearly defines the rights and responsibilities of the owners, and provides a workable framework for operating, financing, transferring, and ultimately disposing of real estate. The effectiveness of an LLC or LLP depends not only on the statutory protections available, but also on the care taken in structuring, documenting, and operating the entity.