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Business Law

Distributions By a Business Entity - Cautions for Owners and Their Counsel

Before your LLC and corporate clients pay a big distribution to their owners, make sure they aren't opening themselves to claims from disgruntled claimants.

By Sherwin D. Abrams

As a general rule, the owners or managers of a corporation or limited liability company are not personally liable for the obligations of the entity. An important exception applies when the entity is insolvent. For purposes of the Business Corporation Act, 805 ILCS 5/9.10(c), and the Limited Liability Company Act, 805 ILCS 180/25-30(a), a corporation or LLC is insolvent if a) its liabilities exceed its assets (bankruptcy insolvency), or b) it cannot pay its debts as they become due in the ordinary course of business (cash flow insolvency).

The Business Corporation Act and the Limited Liability Company Act restrict a corporation or LLC from making a distribution if the entity is insolvent or is rendered insolvent by virtue of the

distribution. The business organization statutes also restrict these entities from making a distribution that would leave insufficient assets available to those owners who have a preferential right to receive distributions.

The obvious purpose to the imposition of these limitations is to protect the creditors of the entity. An entity must pay its bills before it may make distributions to its owners.

Suppose that an entity does make a distribution that the statute governing the entity prohibits. Who is responsible and to whom? The directors of an insolvent corporation who vote for or who assent to a prohibited distribution are liable to the corporation, but not to its creditors. 805 ILCS 5/8.65(a)(1). Similarly, the managers of a manager-managed LLC are liable to the LLC, but not to its creditors. In the case of a member-managed LLC, the members who vote for or who assent to the distribution are liable to the LLC. 805 ILCS 180/25-35(a).

If a director, manager, or member is liable to the entity, does that person have any recourse against those who received the distribution? In a corporation, the director may recover from the shareholder who received the prohibited distribution, but only if the recipient knew that the distribution was prohibited. 805 ILCS 5/8.65(d). There is no similar provision in the LLC act, but members who knowingly received a prohibited distribution are liable to the company itself. 805 ILCS 180/25-35(b).

While most businesses today are organized as corporations or limited liability companies, yet another entity offers limited liability to its owners: the limited liability partnership. Surprisingly, no provision in the Uniform Partnership Act (1997) imposes liability on partners of a LLP who assent to, vote for, or receive a distribution that renders the partnership insolvent. A partner in a LLP has no personal liability. 805 ILCS 206/306(c).

Uniform Fraudulent Transfer Act

Suppose you are asked to create a new corporation or limited liability company. How can the directors or managers be protected? Consider including a provision in the entity's formative documents that gives directors and managers the right to recover from an owner who received a prohibited distribution, regardless of whether the distributee knew that the distribution was prohibited.

Absent such a provision, can an owner who unknowingly receives a prohibited distribution be liable for it, and if so, to whom? Even where there is no liability under the various business organization acts, a creditor of the entity might be able to set aside the distribution as a fraudulent transfer under the Uniform Fraudulent Transfer Act. 740 ILCS 160/1.

The UFTA imposes liability on those who receive distributions from an insolvent debtor that made the distribution without receiving a reasonably equivalent value in exchange. 740 ILCS 160/6(a). For purposes of UFTA, a debtor is insolvent only if its assets are less than its liabilities. 740 ILCS 160/3(a). Under the UFTA, a debtor who is generally not paying its debts as they become due is presumed to be insolvent, but that presumption is rebuttable. 740 ILCS 160/3(b).

How do directors and managers avoid making a prohibited distribution? In the case of a corporation, a director may avoid liability by relying in good faith on the company's financial statements. 805 ILCS 5/8.65(c). In the case of a LLC, the manager or member is protected unless that person breached the duties imposed by Section 15-3 of the LLC Act. 805 ILCS 180/25-35(a). That section imposes a duty to refrain from engaging in grossly negligent, intentional, or reckless conduct.

If your client proposes payment of a dividend or other distribution to the owners of the business, review and comply with the rules regarding distributions under the law applicable to the specific entity to avoid claims from disgruntled creditors and the embarrassment of having to "claw back" distributions to owners.

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