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WHAT ARE THE LEGAL ISSUES YOUR CLIENTS SHOULD CONSIDER WHEN THEY CONVERT SINGLE-MEMBER LLCs TO MULTI-MEMBER LLCs?

EXECUTIVE SUMMARY

In the previous issue of this newsletter, I discussed the federal income tax consequences that may result under Internal Revenue Service Revenue Ruling 99-5 when a single-member LLC subject to federal income taxation as a disregarded entity is converted to a multi-member LLC taxable as a partnership. In this newsletter, I'll discuss the *legal* issues to which such a conversion may give rise. As shown below, the legal consequences of such a conversion, like the federal income tax consequences, can be major.

DISCUSSION

- 1) Amendment of certificate of formation not required. When the LLC converts from a single-member LLC to a multi-member LLC, its members will not have to file an amendment of its certificate of formation with the New Hampshire Secretary of State unless they want to change its management structure or other legal features provided for in its original certificate of formation. In other words, a mere change in the number of the members will not necessitate such a filing.
- 2) General rule—no legal changes vis a vis third parties. Furthermore, no legal relationship of the converting LLC with third parties is likely to change as a result of the conversion. For example, the LLC will continue to own all of the assets that it owned before the conversion, and there will be no change in its contract rights and duties unless the contract parties have previously agreed otherwise. Thus, unless there are specific contractual arrangements to the contrary, the conversion will have no effect on any government permit, vehicle registration, real or personal property

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lease agreement, loan agreement, license agreement; employment agreement or independent contractor agreement to which the LLC is a party.

- 3) Third-party notification issues. Furthermore, when an LLC converts from a single-member LLC to a multi-member LLC, the members generally will have no statutory or other legal duty either before or after the conversion to notify any third parties about the conversion. However, it will be wise for the members to give notice to third parties who have contractual relations with the LLC that could cause problems if these third parties find out about the conversion on their own.

For example, if there is a significant change of ownership of an LLC, it's possible that under the relevant loan document, a bank or other lender may have the right to accelerate the pay-off of a loan or line of credit. Members should consider this possibility before converting a single-member LLC to a multi-member LLC and, if necessary, should address the acceleration issue with the lender in question before the conversion. Members and prospective members considering the conversion of a single-member LLC to a multi-member LLC should take this possibility into account before the conversion.

- 4) Personal guarantees. If the member of a single-member LLC was required by a third party to be guarantor of LLC liabilities—e.g., liabilities under a loan agreement or real property lease agreement—the third party may also want to impose a guarantee obligation on any additional member.
- 5) Workers' compensation. Under New Hampshire law, any three members of an LLC may elect to be exempt from the New Hampshire workers' compensation system. Before a single-member LLC converts to a multi-member LLC, the member and the prospective new members should consider their post-conversion workers' compensation strategy. If the conversion will result in the LLC's having *more* than three members, this consideration may be complex.
- 6) The need for a new LLC agreement. The conversion of a single-member LLC to a multi-member LLC will normally require the members of the converted entity to negotiate in considerable detail the legal relationship between them and to reach agreement on all relevant issues. Addressing these issues may require the assistance of a lawyer experienced in planning, negotiating and drafting LLC agreements; and the lawyer's fee for performing these tasks may be significant. However, a failure to address them may eventually be far more costly to the members, especially if, after the conversion, disputes arise between them about their LLC.

In the next issue of this newsletter, I will discuss the main LLC agreement issues that members and prospective members should address when considering the conversion of single-member LLCs to multi-member LLCs.