

Admitted to practice in Massachusetts and New Hampshire

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 32 (JUNE 12, 2006)

CONVERSIONS OF SINGLE-MEMBER LLCs TO MULTI-MEMBER LLCs—13 ISSUES YOUR CLIENTS SHOULD ADDRESS WHEN THEY NEGOTIATE THEIR LLC AGREEMENT

EXECUTIVE SUMMARY

In Issue 30 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 New Hampshire LLC subject to federal income taxation as a disregarded entity is converted to a multi-member New Hampshire LLC taxable as a partnership. In Issue 31, I discussed the important *legal* consequences to which such a conversion may give rise.

However, in these previous newsletter issues, I did not address the legal and tax questions that will arise when the original LLC member and his or her new co-member negotiate the LLC agreement between them. In this newsletter, I will address these questions. First, however, it will be useful to address the question whether the original and new members will need an LLC agreement at all.

DISCUSSION

The need for a sound, written LLC agreement. In the case of a multi-member LLC, an LLC agreement is, in effect, the partnership agreement among the members; it defines the nature of the LLC's business and the rights and duties of the members. In any multi-member LLC that involves significant financial or personal stakes, there are three main reasons why the members should negotiate and sign a comprehensive LLC agreement:

- The need to change statutory default rules that don't work for the LLC in question. First, there are several "default rules" in the New Hampshire Limited Liability Company Act that, for many multi-member LLCs, simply do not work. For example, the New Hampshire LLC Act provides, in effect, that the LLC will make no distributions of cash to the members unless the LLC agreement specifically requires them. However, most LLC members want the LLC to distribute to them, at the very least, enough cash to enable

them to pay any federal and state taxes they may owe on their shares of LLC income on time and in full.

- The need to address “statutory gaps” in the New Hampshire LLC Act. Second, there are many important multi-member LLC legal issues that the New Hampshire LLC Act simply does not address or addresses inadequately—for example, issues concerning members’ duties of care and loyalty, and, in particular, their duty not to compete against the LLC.
- LLC agreements as teaching documents and users’ manuals. Third, even apart from purely legal considerations, well-drafted LLC agreements can be invaluable teaching documents for persons considering becoming members of an LLC and users’ manuals after the LLC is formed.

However, under the New Hampshire LLC Act, a merely verbal agreement among the members of an LLC will be invalid; the Act requires that LLC agreements be in writing. (By contrast, oral “operating agreements”—the term for LLC agreements under the Massachusetts LLC Act—are valid; but if there are member disputes, these written agreements are likely to be worthless, since it is normally very hard to prove to a judge or jury the contents of oral agreements.)

It is possible to find good forms for LLC agreements on the Internet. However, to my knowledge, there are no such forms that are tailored for use under the New Hampshire LLC Act, much less for the unique needs of specific LLCs and their members. Thus, if the members of a multi-member LLC decide they need such an agreement, they should seriously consider hiring (i) a competent LLC lawyer to help them negotiate and draft it; and (ii) a good tax professional (whether he or she is a CPA, an enrolled agent or a tax lawyer) to advise them on how to resolve the federal and state tax issues that they and their LLC will inevitably confront. If the same professional can help them with both their legal and their tax issues, so much the better.

LLC agreement issues. What should be the contents of an LLC agreement under the New Hampshire LLC Act? In my view, every good LLC agreement for a multi-member LLC under the New Hampshire LLC Act should do the following:

- 1) Alteration of statutory default rules that don’t work for the deal in question. As I’ve mentioned, the LLC agreement should alter all of the default rules of the New Hampshire LLC Act that do not fit the LLC deal in question.
- 2) Filling of “statutory gaps.” As I’ve indicated, the LLC agreement should address all of the legal and tax issues between the members that aren’t addressed by the New Hampshire LLC Act.
- 3) “Introductory” issues. The LLC agreement should contain provisions concerning the name of the LLC, the identities of its members, its principal place of business, its taxable year, its method of accounting, and other basic “introductory” issues.
- 4) Basic financial provisions. The LLC agreement should address all basic issues among the members concerning their contributions to the LLCs, their rights to allocations of LLC income and losses, their rights to distributions of LLC cash and

other assets, their capital accounts, and their compensation for services to or for the LLC.

- 5) Events of dissociation. The LLC agreement should identify the “events of dissociation”—i.e., events, such as death, disability, resignation, bankruptcy, expulsion and perhaps divorce, that the members agree should cause members to cease being members.
- 6) Buy-sell provisions. The LLC agreement should contain comprehensive buy-sell provisions that specify when the LLC can issue ownership interests to existing and new members; when the members can sell their memberships to other persons; and what rules, including price and non-price provisions, should govern LLC buy-outs of deceased and other dissociated members.
- 7) Member meetings, voting and information rights. The LLC agreement should contain reasonably comprehensive rules concerning member meetings and members’ voting and information rights.
- 8) Manager titles, etc. The LLC agreement should contain rules concerning managers’ titles, appointments, removals and functional responsibilities.
- 9) Fiduciary duties. As I’ve indicated above, the LLC agreement should contain clear rules concerning the duty of care, duty of loyalty, duty of confidentiality and other important ethical and fiduciary duties that the members will have toward one another.
- 10) Claims by members and managers. The LLC agreement should contain rules governing claims by members and managers against one another. These rules should generally provide that claims may be brought only in arbitration and not in court.
- 11) Federal income tax rules. If the members and their tax advisers agree that the LLC should be taxable as a partnership, the LLC agreement should contain all of the tax provisions required by Subchapter K for the LLC in question. If the LLC will be an S corporation for federal income tax purposes, the LLC agreement should contain the very different federal income tax rules that are necessary under Subchapter S.
- 12) New Hampshire tax provisions. The LLC agreement should contain provisions that will protect the LLC’s members to the extent possible from Social Security Taxes and the New Hampshire Interest and Dividends Tax and that will protect the LLC itself from the New Hampshire Business Profits Tax. (The Interest and Dividends Tax can be avoided by appropriate provisions in the LLC agreement restricting transfers of membership rights and providing for dissolution upon these transfers. The BPT can be avoided by appropriate compensation provisions, by a “Qualified Investment Company” election if appropriate and by various other means.)
- 13) “Miscellaneous” provisions. The LLC agreement should contain provisions about various significant “miscellaneous” questions, such as LLC books and records, outside tax and legal advisers, dissolution, and questions about amendments, governing law, waivers and other “boilerplate” issues.