

**JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS**

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**WHEN A MULTI-MEMBER LLC BECOMES A
SINGLE-MEMBER LLC—
TAX AND LEGAL RULES YOUR CLIENTS
SHOULD KNOW**

EXECUTIVE SUMMARY

Because of a member's death or otherwise, multi-member LLCs often change to single-member LLCs. When this change occurs, dangerous legal and tax consequences can easily result. The present issue of this newsletter addresses the principal legal consequences of such a change. In so doing, it focuses primarily on changes of two-member LLCs to single-member LLCs, and it assumes that these two-member LLCs have only individuals as members. However, the legal points below will often apply equally to multi-member LLCs with three or more members, including one or more members that are entities.

A forthcoming issue of the newsletter will consider the tax consequences of such a change.

DISCUSSION

- 1) Preparing for the change. As soon as the members of a multi-member LLC know that their LLC will soon change to a single-member LLC, they should consider consulting with an accountant and a lawyer with LLC expertise as to the tax and legal issues that will arise from the change. Both the legal and the tax issues can come as surprises; and many of them may arise from local law or from facts unique to the LLC in question. As illustrated below, handling these issues may be impossible except on the basis of advance preparation.
- 2) "Events of dissociation," etc. Under the New Hampshire Limited Liability Company Act and every other state LLC act, a potentially wide variety of events—called "events of dissociation"—can cause LLC members to cease being members and thus to cause a two-member LLC to change to a single-member LLC. The principal such events are (i) the death of a member who is an individual; (ii) the dissolution of a member who is an entity; (iii) the disability of an individual member; (iv) member resignation; (v) member bankruptcy; (vi) member buy-out (whether by cross-purchase or by redemption by the LLC); (vii) a member's expulsion; and (viii) under many LLC agreements, a member's divorce.

The statutory legal consequences of events of dissociation vary widely from event to event and from one LLC act to another, and these consequences can often be heavily affected by any LLC agreement that may apply among the members. As indicated above, LLCs and their members should prepare in advance for these consequences. Preparing in a competent manner usually requires a carefully negotiated written agreement among the members.

- 3) New LLC agreement. By definition, a single-member LLC owned by an individual is subject to complete control by that individual. Thus, it may seem counterintuitive that such an LLC needs a written LLC agreement. However, the need is clear and urgent. Among other considerations:
 - a) The New Hampshire Limited Liability Company Act contains numerous default statutory rules that simply don't work for many single-member LLCs—e.g., the rule that if an LLC member becomes personally bankrupt, he or she is no longer a member. Under the New Hampshire Act, this and other unworkable statutory rules not only need to be changed; they can only be changed in a legally binding manner through a *written* LLC agreement.
 - b) A written LLC agreement can be an invaluable means for providing the members of single-member LLCs with a clear understanding of the legal and tax structure of their LLCs and its proper administration. If the LLC is taxable as an S corporation (which is by far the best federal tax regimen for many New Hampshire single-member LLCs), the guidance of a written LLC agreement can be particularly important.
- 4) What should be the contents of LLC agreements for single-member LLCs?
 - a) Statement of background. It will often be useful to begin the LLC agreement of a LLC that has changed from a multi-member LLC to a single-member LLC with a statement of background (often referred to by lawyers as “recitals”) that gives a brief history of the LLC and, in particular, specifically notes this change. This statement can provide an indispensable context in addressing LLC issues that arise after the change.
 - b) Basic LLC information. The LLC agreement should provide basic information about the LLC's name, management structure, method of accounting, taxable year and tax structure.
 - c) Alteration of default rules. The LLC agreement should alter the above “dissociation upon bankruptcy” rule and all other default rules in the governing LLC act that are unsuitable for single-member LLCs owned by individuals.
 - d) Assistant manager. In most cases, the LLC agreement should appoint the member as the manager of the LLC, but it should also appoint as an assistant manager a person trusted by the member; and it should provide that if, because of the death or disability of the member or the occurrence of other specifically identified circumstances, the assistant manager may validly act as the manager. This will ensure continuity of LLC management if something happens to the member.

- e) Contributions. The LLC should state the amount of any contribution made by the member to the LLC; and if the member owes no contribution (as will usually be the case when a multi-member LLC changes to a single-member LLC), it should so state.
 - f) Subchapter S issues. As noted, if the LLC was originally an S corporation or elects to be taxable as an S corporation, the LLC agreement should provide various guidelines for ensuring the preservation of the LLC's S election.
- 5) LLC certificates of formation. The certificate of formation of many multi-member LLCs provides that these LLCs are "member-managed"—i.e., that any member can sign contracts for the LLC and otherwise participate in its management. When a multi-member LLC changes to a single-member LLC, it may be necessary to amend the LLC's certificate in various ways, but particularly to provide that it is *manager*-managed, since, without this change, the single-member LLC's assistant manager may well lack the legal authority to act for the LLC.
- 6) Contracts and insurance policies, etc. In general, the fact that an LLC changes from a multi-member LLC to a single-member LLC should not affect the validity of any contracts to which it is a party, including, for example, insurance contracts, real and personal property lease agreements, line-of-credit agreements and mortgage agreements. However, loan agreements and mortgage agreements often have provisions that call for acceleration of repayment upon a change of ownership; and many debt agreements and real estate and personal property lease agreements to which LLCs are parties include provisions for personal guarantees by members. Thus, before a multi-member LLC changes to a single-member LLC, the members should review all of their loan agreements and other contracts to ensure that the change will have no adverse contractual consequences.
- 7) Post-dissociation competition. When a member of a multi-member LLC is dissociated from the LLC, this can sometimes create a risk that eventually, if not immediately, the dissociated member will compete with the LLC, use its customer list, seek to hire away its employees, or interfere in some manner with its suppliers or other key third parties with whom the LLC does business. The best way to prevent these various consequences is through a written agreement between the departing member and the remaining members that is signed by the parties *before* the departing member is dissociated.
- 8) Veil-piercing. Single-member LLCs are often more vulnerable than multi-member LLCs to veil-piercing claims in state and federal courts—i.e., to claims by third parties that the members' personal assets should be at risk in claims against the LLC. Thus, when a multi-member LLC changes to a single-member LLC, its member should carefully consider whether he or she is taking all necessary measures to prevent such claims. The February 1, 2004 issue of this newsletter (archived on my website) provides several anti-veil piercing guidelines that these individuals may wish to consider.