

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

ISSUE NO. 57 (DECEMBER 16, 2008)

**WHAT ACCOUNTANTS SHOULD KNOW ABOUT THE
FINANCIAL PROVISIONS OF THE NEW HAMPSHIRE
LIMITED LIABILITY COMPANY ACT**

PART I—INTRODUCTION AND OVERVIEW

EXECUTIVE SUMMARY

There are 25 principal provisions in the New Hampshire Limited Liability Company Act (the “New Hampshire Act”) that address basic LLC financial matters involving contributions, allocations, distributions and member buy-outs. Accountants who represent clients forming or operating New Hampshire LLCs should have a reasonably detailed knowledge of all of these provisions and a thorough knowledge of the 13 most important of them.

DISCUSSION

I. INTRODUCTION

- 1) Financial vs. non-financial issues in LLC formations and operations. The main reason most LLC members join their LLCs is to make money. Thus, to the extent that these members spend time thinking about the legal structure of their LLC, they are probably thinking about LLC financial rules. And these financial rules, rather than purely legal rules, must obviously be the primary LLC concerns of accountants.
- 2) The financial provisions of the New Hampshire Act. By my count, there are 186 provisions of the New Hampshire Act that are likely to be significant in the formation and operation of LLCs formed under that Act. Of these 186 provisions, my review indicates that 25 provisions address basic LLC financial issues. All of these provisions are identified in the attached Exhibit A, and this table indicates whether each of these provisions is a definitional, mandatory, default or permissive provision.¹ Accountants who assist clients in forming and operating New Hampshire LLCs must have a solid basic knowledge of all of these provisions, and they must have a thorough knowledge of those provisions whose financial or tax implications are unclear in any significant respect or which contain financial or tax pitfalls for their clients.

¹ The distinctions among the definitional, mandatory, default and permissive provisions of LLC acts and the practical importance of these distinctions are explained in Issue No. 56 of this newsletter. Issue No. 56 is archived in www.llcformations.com.

- 3) Paragraphs 4 through 6. The 13 financial provisions of the New Hampshire Act that are likely to be the most important to most LLCs, their members and their managers are summarized in Paragraph 4 of this newsletter. Certain significant financial issues that arguably ought to be but are not addressed in the Act are addressed in Paragraph 5. Paragraph 6 briefly addresses issues concerning redemption terms and concerning cross-purchases. Future issues of this newsletter will focus on significant financial provisions of the Act whose meanings are unclear or which contain pitfalls.
- 4) Key New Hampshire Act financial provisions. In my view, the most important financial provisions of the New Hampshire Act are the following:
 - (1) Section 78,II—mandatory rule providing for freedom of contract and for enforceability of LLC agreements. Section 78, II of the New Hampshire Act provides in essence that members of New Hampshire LLCs shall have maximum freedom of contract in tailoring their LLCs in their LLC agreements to meet their needs and interests, and that the courts must give maximum effect to these agreements.² Although Section 78,II makes no specific reference to LLC financial issues, the section by clear implication provides New Hampshire accountants and lawyers with a sweeping charter of creativity in devising and implementing financial arrangements for their clients’ benefit. Many of the other provisions summarized below merely implement this manifest intent of Section 78,II.
 - (2) Section 1,VII—definition of “limited liability company interest.” Section 1,VII defines the key New Hampshire Act term “limited liability company interest.” Under Section 1,VII, limited liability company interests mean:
 - (a) The right of members to receive allocations of LLC profits and losses; and
 - (b) Their right to receive distributions of LLC cash and other assets.³
 - (3) Section 36,I—permissive rule concerning permitted types of contributions. Section 36,I provides that in exchange for their limited liability company interests and their other rights as members of their LLCs, members may make contributions in the form of:
 - (a) Cash, property, or services; and
 - (b) Promises to contribute cash, property or services.⁴
 - (4) Section 24,I—permissive rule concerning classes of members. Section 24,I

² Section 78,II provides as follows: “It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”

³ Section 1,IV provides as follows: “‘Limited liability company interest’ means a member’s share of the profits and losses of a limited liability company and a member’s right to receive distributions of the limited liability company’s assets.

⁴ Section 36,I provides as follows: “The contribution of a member to a limited liability company may be in cash, property or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.

provides that LLC agreements may provide for two or more classes of memberships. By unmistakable implication, the section permits these classes to provide not only for differing *management* rights but also for differing *financial* rights.⁵

- (5) Section 38 (first sentence)—permissive rule concerning permitted types of formulas in LLC agreements for allocations of LLC profits and losses. The first sentence of Section 38 provides in effect that in their LLC agreements, LLC members may allocate the profits and losses of their LLCs on the basis of any formula they wish as long as all of them agree on this formula in their LLC agreement.⁶
- (6) Section 38 (second sentence)—default rule concerning formulas in LLC agreements for allocations of LLC profits and losses. The second sentence of Section 38 provides that unless the LLC agreement provides otherwise, the profits and losses of an LLC shall be allocated among the members in proportion to the value of their respective contributions of cash, property and services.⁷
- (7) Section 39 (first sentence)—permissive rule concerning formulas in LLC agreements for allocations of distributions of LLC profits and losses. The first sentence of Section 39 provides in effect that in their LLC agreements, LLC members may allocate interim distributions to the members on the basis of any formula they wish as long as all of them agree on this formula in their LLC agreement.⁸ Thus, for example, even if the LLC agreement of an LLC allocates its profits equally among the members, this agreement may also provide that all interim *distributions* shall be made to a single identified member.⁹ Effectively, because of the default rule of Section 40, such an agreement must be read to provide that all other members will receive *no* interim distributions and that the *only* distributions they receive will be *liquidating* distributions.

⁵ Section 24,I provides in relevant part as follows: “A limited liability company agreement may provide for classes or groups of members having such relative rights, powers and duties as the limited liability company agreement may provide. . . .”

⁶ LLC allocations mean accruals on the books of the LLC of the members’ respective shares of LLC profits and losses. In essence, allocations are mere book entries. As noted below, LLC distributions mean *actual transfers* of LLC cash or other assets to members in their capacity as members.

⁷ Section 38 (second sentence) provides as follows: “If the limited liability company agreement does not [expressly provide for allocations of profits and losses], profits and losses shall be allocated on the basis of the value, as of the date of contribution, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.”

⁸ Distributions by an LLC mean the LLC’s transfer of cash or other assets to its members simply because they are members and not because of, for example, their services to the LLC. Interim distributions mean all distributions except liquidating distributions. Liquidating distributions mean (i) distributions to the members before the liquidation of their LLC; and (ii) distributions by the LLC to a dissociated member to redeem that member’s membership rights.

⁹ Section 39 (first sentence) provides as follows: “Distributions of cash or other assets of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in the limited liability company agreement.”

- (8) Section 39 (second sentence)—default rule concerning formulas in LLC agreements for allocations of distributions of LLC profits and losses. The second sentence of Section 39 provides that unless the LLC agreement provides otherwise, interim distributions shall be allocated among the members in proportion to the value of their respective contributions of cash, property and services to the LLC.¹⁰
- (9) Section 40—default rule concerning the right of members to receive interim distributions. Section 40 of the New Hampshire Act provides in effect that unless the LLC agreement provides otherwise, LLC members shall have no right to interim distributions from their LLC except to the extent required in the LLC agreement.¹¹
- (10) Section 41 (first clause of first sentence)—default rule concerning the right of dissociated members, upon their dissociation, to receive distributions of amounts allocated to them before their dissociation. The first clause of the first sentence of Section 41 provides in effect that unless the LLC agreement provides otherwise, a member who is dissociated from an LLC (i.e., whose membership is terminated by reason of death or otherwise) will not be entitled to receive distributions of amounts allocated to the member before the member’s dissociation.¹²
- (11) Section 41 (second clause of first sentence)—default rule concerning the right of dissociated members, upon their resignation, to buy-outs of their membership rights. The second clause of the first sentence of Section 41 provides in effect that unless the LLC agreement provides otherwise, a member that is dissociated from an LLC will have no right to require the LLC to redeem (i.e., to buy out) the member’s membership rights.¹³
- (12) Section 41 (second sentence)—mandatory rule concerning status of certain dissociated members as “assignees.” The second sentence of Section 41 provides in effect that if a member is dissociated from an LLC and is not bought out by the LLC or by the other members, the dissociated member will have the status of an assignee of a limited liability company interest. This

¹⁰ The second sentence of Section 39 provides as follows: “If the limited liability company agreement does not [provide for allocations of distributions], distributions shall be made on the basis of the value, as of the date of contribution, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.”

¹¹ Section 40 provides in pertinent part as follows: “[T]o the extent and at the times or upon the occurrence of the events specified in the limited liability company agreement, a member is entitled to receive from a limited liability company distributions before cessation of the member’s membership pursuant to RSA 304-C:27 and before the dissolution and winding up of the limited liability company.”

¹² The first clause of the first sentence of Section 41 provides in relevant part as follows: “[A]ny member, upon ceasing to be a member pursuant to RSA 304-C:27, is entitled to receive any distribution to which the member is entitled under a limited liability company agreement. . . .”

¹³ The second clause of the first sentence of Section 41 provides in pertinent part as follows: “[U]nless otherwise provided in a limited liability company agreement, the member is not entitled to receive any payment for the value of the member’s limited liability company interest as of the date of cessation of membership based upon the member’s right to share in distributions from the limited liability company.

means, in effect, that until a dissociated member is bought out, the member will be entitled to receive allocations of LLC profits and losses and distributions of LLC cash and other assets.¹⁴

(13) Section 58,II—mandatory rule concerning liquidating distributions. Section 58,II provides, in effect, that in connection with its liquidation, an LLC must first pay its creditors and that, after making these payments, it must then make distributions to the members in accordance with the rules of the New Hampshire Act governing interim distributions.¹⁵

- 5) Significant LLC financial issues that the New Hampshire Act does not address. In my view, the significant LLC financial issues that the New Hampshire Act arguably ought to but does not address are as follows:
- (1) Definitions. The New Hampshire Act does not define the key financial term “allocation [of profits]”; it provides no definition for the key general term “distribution”; and it provides no definition of the key terms “interim distribution” and “liquidating distribution.”
 - (2) Scope of member redemptions. The New Hampshire Act does not make clear that redemptions of LLC members’ rights must be interpreted to include redemptions not only of their limited liability company interests but also of all of their other membership rights (including, for example, voting rights, agency rights, information rights, fiduciary rights and dispute resolution rights).
- 6) Redemptions and cross-purchases—closing terms, etc. Among the most important provisions in any LLC agreement are those defining the right of members, upon their death or other dissociation, to require the LLC to redeem their membership rights or to require the other members to “cross-purchase” (i.e., to buy out) these rights. Two provisions addressed above—namely, the first and second sentences of Section 41—

¹⁴ The second sentence of Section 41 provides as follows:

If the member ceasing to be a member receives no payment for the value of the member’s interest in the limited liability company, the member ceasing to be a member shall continue to have the rights of an assignee of a limited liability company interest under RSA 304-C:46, II, subject to the limited liability company’s right of offset under RSA 304-C:27, III.

¹⁵ Section 58,II provides as follows:

II. Upon the winding up of a limited liability company, the assets shall be distributed as follows:

- (a) Payment, or adequate provision for payment, shall be made to creditors, including, to the extent permitted by law, members who are creditors in satisfaction of liabilities of the limited liability company;
- (b) Unless otherwise provided in a limited liability company agreement, to members and former members in satisfaction of liabilities for distributions under RSA 304-C:40 or RSA 304-C:41; and
- (c) Unless otherwise provided in a limited liability company agreement, to members first for the return of their contributions and second respecting their limited liability company interests, in the proportions in which the members share in distributions.

address in general terms key member issues relating to member redemptions. However, no term of the Act addresses issues relating to the closing of redemptions and other redemption terms; and none addresses any issue related to cross-purchases of dissociated members' membership rights.

However, these issues, by their very nature, normally must be addressed in a significantly tailored manner in order to meet the unique needs and interests of the LLCs and LLC members in question. Thus, they are issues that, in the case of many LLCs, cannot be meaningfully addressed in an LLC statute, but rather, only in a well-drafted LLC agreement.

If you have comments on this column or wish to contact me for any other reason, please send me an e-mail at lawjmc@comcast.net or give me a call at (603) 228-0125. If you'd like to visit my website, the link is www.llcformations.com.

EXHIBIT A

TABLE

**PRINCIPAL FINANCIAL PROVISIONS
IN THE NEW HAMPSHIRE LIMITED LIABILITY COMPANY ACT**

Preliminary notes.

1. Overview of table. This table (the “Table”) identifies and quotes or briefly summarizes the principal provisions in the New Hampshire Limited Liability Company Act (the “Act”) that relate to financial matters. These matters include, for example, contributions by members to their LLCs; allocations of profits and losses and allocations of distributions by LLCs to their members, and interim and liquidating distributions by LLCs to their members. Direct quotes from the Act are indicated in the Table by quotation marks. Paraphrases of provisions of the Act are indicated in the Table by brackets.
2. Abbreviations in table. The following abbreviations in the Table indicate the following types of provisions:
 - DFT = definitional provision
 - DFL = default provision
 - M = mandatory provision
 - P = permissive provision
3. References to “this chapter.” The phrase “this chapter” in the Table refers to the chapter of New Hampshire statutory law that codifies the Act—namely, Chapter 304-C of Title 28 of the New Hampshire Revised Statutes Annotated.

NUMBER OF PROVISION	CITATION	TYPE	STATEMENT OR PARAPHRASE OF PROVISION
1.	§ 304-C:1,III	DFL	“ <u>Contribution</u> ”—definition. “‘Contribution’ means any cash, property, services rendered or a promissory note or other obligation to contribute cash or property or to perform services, which a person contributes to a limited liability company in the person's capacity as a member.”
2.	§304-C:1,VII	DFL	“ <u>Limited liability company interest</u> ”—definition. “‘Limited liability company interest’ means a member's share of the profits and losses of a limited liability company and a member's right to receive distributions of the limited liability company's assets.”
3.	§304-C:23,III	P	<u>Persons may become members of LLCs without making contributions.</u> “A person may be admitted to a limited liability company as a member of the limited liability company and may receive a limited liability company interest in the limited liability company without making a contribution or being obligated to make a contribution to the limited liability company.”

NUMBER OF PROVISION	CITATION	TYPE	STATEMENT OR PARAPHRASE OF PROVISION
4.	§§ 304-C:24,I & II	P	<u>Classes of members, taking of actions, etc.</u> [These provisions permit LLC agreements to provide for classes of members; for the future creation of classes of members; and for the taking of actions, including the amendment of the LLC agreement, without a vote of a particular class.]
5.	§304-C:36,I	P	<u>Permissible contributions.</u> “The contribution of a member to a limited liability company may be in cash, property or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.”
6.	§304-C:37,I	M	<u>Enforceability of promises to make contributions.</u> “A promise by a member to contribute to the limited liability company is not enforceable unless set forth in a writing signed by the member.”
7.	§ 304-C:37,II (first sentence)	DFT	<u>Obligation to contribute not affected by death, etc.</u> “Except as provided in a limited liability company agreement, a member is obligated to a limited liability company to perform any enforceable promise to contribute cash or property or to perform services, even if he is unable to perform because of death, disability or any other reason.”
8.	§ 304-C:37,II (second sentence)	M	<u>Options available to LLC if a member fails to contribute promised property or services.</u> “If a member does not make [a] required contribution of property or services, he is obligated at the option of the limited liability company to contribute cash equal to that portion of the agreed value of the contribution that has not been made.”
9.	§ 304-C:37,III (first sentence)	DFT	<u>Compromises of promises to contribute.</u> “Unless otherwise provided in a limited liability company agreement, the obligation of a member to make a contribution or return money or other property paid or distributed in violation of this chapter may be compromised only by consent of all the members.”
10.	§ 304-C:37,III (second sentence)	M	<u>Creditors’ rights concerning contributions.</u> “Notwithstanding [a compromise under Section 304-C:37,III (first sentence)], a creditor of a limited liability company who extends credit, or otherwise acts, in reliance on that obligation after the member signs a writing that reflects the obligation and before the compromise, may enforce the original obligation.”
11.	§ 304-C:37,IV (first sentence)	P	<u>Penalties for failure to contribute.</u> “A limited liability company agreement may provide that the interest of any member who fails to make any contribution that the member is obligated to make shall be subject to specified penalties for, or specified consequences of, such failure.”

NUMBER OF PROVISION	CITATION	TYPE	STATEMENT OR PARAPHRASE OF PROVISION
12.	§ 304-C:37,IV (second sentence)	P	<u>Types of penalties for failure to contribute.</u> [This provision authorizes LLCs to impose various specified types of penalties on members who fail to make promised contributions.]
13.	§ 304-C:38 (first sentence)	P	<u>Allocations of profits and losses—permissive rule.</u> “The profits and losses of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in a limited liability company agreement.”
14.	§ 304-C:38 (second sentence)	DFT	<u>Allocations of profits and losses—default rule.</u> “[Unless the limited liability company agreement provides otherwise], [the] profits and losses [of a limited liability company] shall be allocated on the basis of the value, as of the date of contribution, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.”
15.	§ 304-C:39 (first sentence)	P	<u>Allocations of distribution—permissive rule.</u> “Distributions of cash or other assets of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in a limited liability company agreement.”
16.	§ 304-C:39 (second sentence)	DFT	<u>Allocations of distributions—default rule.</u> “[Unless the LLC agreement provides otherwise,] distributions of cash or other assets of a limited liability company shall be made on the basis of the value, as of the date of contribution, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.”
17.	§ 304-C:40	DFT	<u>Members’ right to interim distributions.</u> “Except as provided in this subdivision, to the extent and at the times or upon the occurrence of the events specified in the limited liability company agreement, a member is entitled to receive from a limited liability company distributions before [the member’s dissociation] and before the dissolution and winding up of the limited liability company.” [This section may be read as providing in effect that unless a limited liability company agreement provides for interim distributions, the members shall have no right to these distributions.]
18.	§ 304-C:41 (first clause)	M	<u>Distributions to dissociated members.</u> “Except as provided in this subdivision, [a dissociated member] is entitled to receive any distribution to which such member is entitled under a limited liability company agreement.”

NUMBER OF PROVISION	CITATION	TYPE	STATEMENT OR PARAPHRASE OF PROVISION
19.	§ 304-C:41 (second clause)	DFT	<u>Dissociated member has no right to receive fair value of limited liability company interest, etc.</u> “[U]nless otherwise provided in a limited liability company agreement, [a dissociated] member is not entitled to receive and payment for the value of the member’s limited liability company interest as of the date of [dissociation] based upon such member’s right to share in distributions from the limited liability company.”
20.	§ 304-C:41 (second sentence)	M	<u>Status of dissociated members as assignees with respect to distributions.</u> “If the member ceasing to be a member receives no payment for the value of the member’s interest in the limited liability company, the member ceasing to be a member shall continue to have the rights of an assignee of a limited liability company interest under [the Act].”
21.	§ 304-C:42 (first sentence)	DFT	<u>Members have no right to non-cash distributions.</u> “Except as provided in a limited liability company agreement, a member, regardless of the nature of the member’s contribution, has no right to demand and receive any distribution from a limited liability company in any form other than cash.”
22.	§ 304-C:42 (second sentence)	DFT	<u>Right of member to refuse non-cash distributions.</u> “Except as provided in a limited liability company agreement, a member may not be compelled to accept a distribution of any asset in kind from a limited liability company to the extent that the percentage of the asset distributed exceeds a percentage of that asset which is equal to the percentage in which the member shares in distributions from the limited liability company.”
23.	§ 304-C:43 (first sentence)	DFT	<u>Status of members as LLC creditors with respect to distributions.</u> “Subject to § 304-C:44 [concerning unlawful distributions] and § 304-C:58 [concerning liquidating distributions], and unless otherwise provided in a limited liability company agreement, at the time a member becomes entitled to receive a distribution, the member has the status of, and is entitled to all remedies available to, a creditor of a limited liability company with respect to the distribution.”
24.	§ 304-C:58	M	<u>Liquidating distributions.</u> [This section contains detailed rules governing liquidating distributions by LLCs. The section provides, among other things, that an LLC must pay third-party creditors before making liquidating distributions to members. Although, for convenience, this table identifies the section as containing mandatory rules for distributions to creditors, the section also contains certain default rules relating to non-creditors.]

NUMBER OF PROVISION	CITATION	TYPE	STATEMENT OR PARAPHRASE OF PROVISION
25.	§ 304-C:78,II	M	<u>Freedom and enforceability of contract.</u> “It is the policy of this [Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”

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