

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

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**WHAT SHOULD YOU DO IF A PERSON WHO HAS
PROMISED TO JOIN YOUR CLIENT'S LLC
AND TO MAKE A CONTRIBUTION TO IT
RENEGES ON HIS PROMISE?**

EXECUTIVE SUMMARY

The best way to avoid the potential disasters that can result if a person promises to join a multi-member LLC but then reneges is for all of the prospective members of the LLC to sign a binding "preliminary LLC agreement" as soon as they reach agreement on the basic terms of the comprehensive agreement. However, if the disaster happens, there is a potential remedy in § 304-C:14,II of the New Hampshire Limited Liability Company Act (the "New Hampshire Act").

DISCUSSION

- 1) At a meeting among individuals X, Y and Z, X makes a firm verbal commitment to Y and Z that he will join XYZ, a New Hampshire LLC that Y and Z are planning to form; and he promises that, in exchange for one-third of the profits and losses of XYZ and equal voting power with Y and Z, he will contribute \$100,000 to XYZ immediately after its formation.
- 2) However, several days later, when Y and Z ask him to sign the final draft of XYZ's LLC agreement and make his contribution, X tells them that he's changed his mind and won't sign. XYZ's LLC agreement lists X as a party to the agreement; it provides that each of the parties will be bound by the agreement when all of them have signed it; and it provides that X must contribute \$100,000 to XYZ promptly after its formation. However, the agreement does not address the issue of what should happen if a person who has promised to join the LLC thereafter refused to sign the agreement.
- 3) X's refusal to sign XYZ's LLC agreement is a disaster for Y and Z, since, on the basis of X's clear promise, they have made major commitments with third parties. You are the lawyer for Y and Z. What should you advise Y and Z to do in this situation?
- 4) The starting point in answering this question is § 304-C:23,I of the New Hampshire Act (which I'll refer to here simply as "§ 23,I"). This section provides in essence as follows:

- a) The prospective members of an LLC may resolve in their LLC agreement the issues as to (i) when a person will be admitted as a member of the LLC in connection with its formation and (ii) under what conditions the person will be admitted.
 - b) However, if the LLC agreement does not address these issues, then the person will be deemed to be admitted as a member of the LLC on the later of (a) the date of formation of the LLC; and (b) the date on which the person's admission is "reflected in the records" of the LLC.^{1, 2}
- 5) The other key provision in dealing with X's breach of his promise to Y and Z is RSA § 304-C:14,II ("§ 14,II"). This section provides, in essence, that if a person that is "required" to execute an LLC agreement refuses to sign it, any person who is "adversely affected" by the refusal may petition the New Hampshire Superior Court to order the person to sign it.³ Here, Y and Z are clearly "adversely affected" by X's refusal to sign XYZ's LLC agreement. The courts will have to tell us the precise meaning of the word "required" in § 14,II. However, I believe that a person becomes "required" to sign an LLC agreement under the section not only if, as in the XYZ case, "adversely affected" persons are injured by their reliance on the defendant's promise but also merely on the basis of the promise itself.
- 6) Thus, what Y and Z should do in order to force X to fulfill his promise to them is to seek a Superior Court order under § 14,II directing X to sign the LLC agreement. Once X complies with the order, he will also be bound to make his \$100,000 contribution, and Y and Z will avert the above disaster.⁴ And if he refuses to sign the agreement, he will be in contempt of court.

¹ Section 23, I provides in its entirety as follows:

304-C:23 Admission of Members. –

I. In connection with the formation of a limited liability company, a person acquiring a limited liability company interest is admitted as a member of the limited liability company upon the later to occur of:

- (a) The formation of the limited liability company; or
- (b) The time provided in and upon compliance with the limited liability company agreement or, if the limited liability company agreement does not so provide, when the person's admission is reflected in the records of the limited liability company.

² It should be noted that under § 28,I(d) of the New Hampshire Act, there can be no doubt that an LLC agreement is a "record of the LLC" within the meaning of § 23,I(b) (second clause).

³ Section 14,II provides in its entirety as follows:

304-C:14 Execution, Amendment or Cancellation by Judicial Order. –

II. If a person required to execute a limited liability company agreement or amendment of such an agreement fails or refuses to do so, any other person who is adversely affected by the failure or refusal may petition the superior court to direct the execution of the limited liability company agreement or amendment of such agreement. If the court finds that the limited liability company agreement or amendment of such an agreement should be executed and that any person required to execute the limited liability company agreement or amendment thereof has failed or refused to do so, it shall order such person to execute such agreement or amendment or enter an order granting other appropriate relief.

- 7) The great value of § 14,II is that it overrides the normal equitable rule that judges will not issue “injunctions” against a defendant—i.e., they will not order the defendant to do something or to refrain from doing something—if the defendant’s misconduct in question can be remedied by money damages. In the XYZ situation, the issue whether money damages may be an adequate remedy for Y and Z may be very unclear. Section 14,II protects Y and Z from having to litigate that issue or to comply with other traditional contract rules that might otherwise apply.
- 8) I am not suggesting that litigation under § 14,II will provide Y and Z with an easy solution to their problem with X. No matter how strong their case, litigation in the Superior Court may be expensive, protracted and emotionally painful for Y and Z; and they will have to bear the burden of proof in seeking an order against X under the section. If they have no written evidence, meeting this burden may be very difficult.
- 9) In view of the risks and potentially heavy costs involved in § 14,II litigation, what should you advise clients who are forming a multi-member LLC if, before you are able to provide a final draft of a comprehensive LLC agreement, they advise you that they suspect one or more of the LLC’s prospective members may breach their stated commitment to join the LLC? In my opinion, the safest course of action is the following: As soon as the prospective members of the LLC have agreed verbally on the principal terms of the LLC deal, you should draft a “preliminary LLC agreement.” This agreement:
 - a) This agreement should clearly state these terms, including terms about who will be the members; and about member contributions, allocations, and distributions.
 - b) It should require each prospective member to agree to sign the final draft of the comprehensive LLC agreement when it is presented to them for signature unless its terms are materially inconsistent with those of the preliminary agreement.
 - c) It should provide that if any irreconcilable conflicts arise among the parties about the terms of the comprehensive agreement, these terms will be determined by an arbitrator.

In my view, § 1,VI(a)(1) strongly supports the effectiveness of “preliminary LLC agreements” in ensuring that written commitments to join LLCs will be enforceable. Section 1,V(a)(1) provides, among other things, that a person will be bound by an LLC agreement if the person has signed *any* writing (not just the LLC agreement) that evidences the person’s intent to join the LLC.^{5, 6}

⁴ Under § 37,II (first sentence) of the New Hampshire Act, members are obligated to perform any enforceable promise to contribute even if they are unable to perform “because of death, disability or any other reason”; and under § 37,III (first sentence), unless the LLC agreement provides otherwise, they can avoid this requirement only “by the consent of all of the members.”

⁵ Section 1,VI(a)(1) provides in its entirety as follows:

A limited liability company agreement *or another written agreement or writing*:

(a) May provide that a person shall be admitted as a member of a limited liability company, or shall become an assignee of a limited liability company interest or other rights or powers of a member to the extent assigned, and shall become bound by the limited liability company 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.

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(1) If such person (or a representative authorized by such person orally, in writing or by other action such as payment for a limited liability company interest) executes the limited liability company agreement *or any other writing* evidencing the intent of such person to become a member or assignee. . . . (Emphasis added.)