

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

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**THE CRITICAL IMPORTANCE OF CORRECTLY
CLASSIFYING LLC STATUTORY PROVISIONS FOR
PURPOSES OF DOING LLC DEALS**

EXECUTIVE SUMMARY

For purposes of properly understanding the potential impact of the provisions of the governing LLC statute in doing an LLC deal, it is critical both to lawyers and to accountants to classify each relevant provision accurately as a definitional, a mandatory, a default or a permissive provision. Making such a classification incorrectly can cause major problems for your clients and, in extreme cases, for you yourself if, because you have made an incorrect classification that results in harm to your client, your client makes an ethics or malpractice claim against you.

DISCUSSION

The basic concepts concerning the above four types of LLC statutory provisions may be summarized as follows:

- 1) Definitional provisions. As its name implies, a definitional provision is a provision in an LLC act that defines the meaning of a specified term as used in the act. It is important for you to be familiar with the definitional provisions in the LLC act that govern an LLC in a deal in which you are representing a client (a "governing act") because, among other considerations, if, in negotiating and drafting an LLC agreement, you use a term inconsistently with its statutory definition and the term becomes the subject of a dispute, the definition a court imputes to the term may conflict with the meaning that favors your client. Most of the definitional terms in the New Hampshire Limited Liability Company Act (the "New Hampshire Act") are in Sections 1, I through 1, XIII. An example of a definitional provision in the New Hampshire Act is Section 1, III, which provides as follows:

III. "Contribution" means any cash, property, services rendered or a promissory note or other obligation to contribute cash or property or to perform services, that a person contributes to a limited liability company in his capacity as a member.

- 2) Mandatory provisions. A mandatory provision in an LLC act is a provision that the parties to an LLC deal may not validly alter in an LLC agreement. It is important that you be familiar with the mandatory provisions of a governing act because, if you include a term in the relevant LLC agreement that conflicts with such a mandatory provision, the latter provision will prevail and may be construed in a manner harmful to your client.
- 3) An example of a mandatory rule in the New Hampshire Act is Section 37, I, which provides as follows:

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.

- 4) You can usually determine that a particular LLC statutory provision is mandatory from the simple fact that, as in Section 37, I, the provision is unqualified and contains no qualifying phrase such as “unless otherwise provided in the limited liability company agreement.” However, sometimes a mandatory rule is hidden in a rule that appears to be a definitional or a default rule. For example, Section 1, VI of the New Hampshire Act provides as follows:

VI. "Limited liability company agreement" means a *written* agreement of the members or a document adopted by the sole member as to the affairs of a limited liability company and the conduct of its business. (Emphasis added.)

- 5) The fact that the above section is contained in Section 1 of the New Hampshire Act, whose caption is “Definitions,” strongly implies that it is merely a definitional provision. However, it is clear from a careful reading of Section 1, VI that the section also contains an implicit but important mandatory rule—namely, that LLC agreements cannot be valid *unless they are in writing*.

- 6) Default provisions. A default provision is a provision which imposes a statutory rule on LLCs or their members or managers but which permits the parties to alter that rule in their LLC agreement. Default provisions can be either express or “covert.” To the extent that the members of an LLC do not alter a default rule in their LLC agreement, they will be bound by that rule.

- 7) Express default provisions normally begin with the phrase “unless otherwise provided in a limited liability company agreement” or a similar phrase. Covert default provisions do not contain such a phrase.

- 8) It is important for you to be familiar with all of the default provisions in the governing LLC act because if the rule contained in any of these provisions is contrary to your client’s best interest, you must seek to expressly alter it in the LLC agreement. Otherwise, the default rule will govern the LLC. In addition, if, on a particular issue, a particular default rule favors your client, then if you can avoid discussion of the issue during LLC agreement negotiations, this may result in a significant benefit for your client “by default.”

- 9) An example of an *express* default provision in the New Hampshire Act is Section 42 (first sentence), which provides as follows:

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.

- 10) An example of a *covert* default provision in the New Hampshire Act is Section 40, which provides in relevant 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.

- 11) In my view, the above provision must be interpreted as providing that unless the limited liability company agreement of an LLC expressly provides for interim provisions of its profits (i.e., distributions other than liquidating distributions), no member is entitled to any such distribution. Obviously, Section 40 is a very dangerous section for members of LLCs taxable as partnerships or S corporations to the extent that these members need interim distributions to enable them to pay federal and state taxes on their shares of LLC income.
- 12) Permissive provisions. A permissive provision is one that expressly permits a specified arrangement in an LLC agreement but does not require the arrangement. It is important for you to be familiar with the permissive provisions of the governing LLC act because (i) these provisions often provide valuable suggestions as to the content of the LLC agreement in question; and (ii) they provide a solid basis for providing opinions to your clients and third parties (e.g., third-party lenders) about the validity of significant arrangements in that agreement.
- 13) An example of a permissive provision in the New Hampshire Act is Section 36, I, which provides as follows:
 - I. 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.

Conclusion. If you understand the above concepts concerning definitional, mandatory, default and permissive provisions in LLC statutes, you will have sound basic equipment for classifying most of the statutory terms in a governing act that are likely to be relevant to LLC formations.

However, under most LLC acts, there are bound to be at least a few terms to which the concepts apply only imperfectly. This is due partly to ambiguities inherent in the English language. For example, in particular circumstances, the seemingly permissive term “may” in a particular LLC statutory provision may function like “shall.”

Furthermore, as already indicated above in the case of Section 1, VI, the same provision in an LLC act may implicitly contain two or more types of provisions—for example, a definitional provision and a mandatory provision.

In future issues of this newsletter, I will address from time to time specific provisions of the New Hampshire Act that illustrate the occasional inadequacy of the interpretative framework I’ve outlined above.

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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