

LLC MEMBERS COME; LLC MEMBERS GO  
LLC HOUSEKEEPING REQUIREMENTS

An Article by  
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For people doing business and doing deals, the limited liability company (LLC) has taken their world by storm. Even though it did not come on to the California scene (as a recognized business entity) until the end of 1994, nearly everybody is now involved in one. It is stated that, in the future, there will only be C corporations and LLCs. In the future, limited partnerships and S corporations as well as general partnerships (including joint ventures) will be historical oddities and will seldom be used.

Different Requirements for Members and Managers Since October of 1994, many managers of LLCs have been replaced, and there have been comings and goings of those who are owners (called “members”). The changes in managers are easily kept current by the annual requirement for the LLC to file its Statement of Information with the Secretary of State – which document requires a disclosure of the LLC managers. There is no California and no federal requirement for a disclosure of members (owners), however. That being the case, there might be a tendency for LLC record-keeping to go undone, for changes in membership to be unrecorded, and for the formalities of adding or deleting members to not be performed.

When a Member Leaves the LLC The departure of a member from a California LLC should trigger some LLC activities. As background, an LLC should, in fact, be looked at though it was a partnership (in actuality it is a partnership that has the corporate protections of limited liability for its owners). Imagine a two person partnership; if one partner leaves, the partnership is terminated because (like a marriage) it takes at least two to make a partnership. (No spouse, no marriage; no partner, no partnership.)

And, upon the departure of any partner, the partners who remain in the partnership are in relatively different relationships with each other than before the departure. As an example: four 25% equal partners become three 33 1/3% equal partners upon the departure of one of them.

Additionally, from a business perspective, a person who is important to the survival or success of the partnership may be the one departing and that might affect the desires of the remaining partners to continue with the LLC venture. So, upon any departure, the technical dissolution of a partnership is accompanied by the practical business considerations that the remaining partners might want to or might not want to continue with the LLC venture.

Upon any departure, at least the following should be done:

- Member Vote For IRS purposes, at least a majority in interest of the remaining members must vote in favor of continuing the LLC. A “majority in interest” of those

who will be eligible to vote must include both LLC profits interest owners as well as LLC capital (ownership) interest owners.

- Minutes of the Vote Minutes should be placed in the LLC Minutes Book to document the vote by that majority in interest to continue the LLC.

When a New Member Joins the LLC The addition of a member to the LLC raises different considerations, but with several requirements for action. An admissions process should be conducted for each potential new member, e.g.:

- Conducting a member vote
- Receiving the financial or other contribution from the new member
- Making the new member sign the LLC operating agreement
- Updating the LLC books and records as to the date of the new member's joining and his/her contribution amount

When Somebody Replaces an Existing Member An existing LLC member might run into financial problems and might have a charging order placed against his/her LLC interests (something like a garnishment). Or, an opportunity might arise for an LLC member to sell all or a portion of his/her LLC interests at an attractive profit - or no profit at all, but just to cash out and eliminate the investment risk. In any of those circumstances, the departing LLC member (after having survived the remaining members' options and first rights to purchase) will offer to the LLC a replacement person for one or both parts of the departing member's LLC interests. That replacement is called the "assignee." The remaining members don't necessarily have to accept the assignee.

Economic Interests of a Member One of the two parts of the departing member's (or any member's) LLC interests is called that member's "economic interests." Economic interests are an LLC member's rights to receive: 1) distributions (cash) from the LLC; and 2) IRS form schedules K-1 that list a member's percent of the profits or loss from the activities of LLC for a particular year.

Assignees of only members' economic interests tend to be creditors (i.e., bill collectors) of defaulting members. However, they can also be people friendly to the assigning member, e.g., a niece who is the recipient of a 5% economic interest in an LLC (as part of her uncle's 25% interest) for having graduated from kindergarten.

In either case, the LLC must honor an assignee of only an economic interest. Following is the minimum required of the LLC to honor such an assignee:

- ~~Conducting a member vote~~ – There is no vote desired and none required.
- ~~Receiving the financial or other contribution from the new member~~
- ~~Making the new member sign the LLC operating agreement~~
- Updating the LLC books and records as to the date of the effect of the charging order against the defaulting member

Membership Interests in an LLC A "membership interest" in an LLC is the other part of the departing member's (or any member's) LLC interests. As opposed to an economic interest, a membership interest is the right to participate in management of the LLC, the

right to obtain information concerning the business and affairs of the LLC, the right to vote on member issues - like the dissolution or merger of the LLC or admission to the LLC of an assignee of a membership interest.

The remaining members don't necessarily have to accept the assignee of a membership interest. California requires at least a majority in interest of the remaining LLC members to vote in favor of an assignee joining them before an assignee can take his or her place at the table as an LLC member. However, having received the required vote, the new member is treated as though s/he had always been there - with all of the rights of a member.

For IRS purposes, it is important that the LLC member vote, to admit an assignee as a member, occurs after the transfer, not before, and that the vote not be predetermined.

When an assignment of a membership interest occurs, at least the following LLC activities should occur:

- Conducting a member vote
- ~~Receiving the financial or other contribution from the new member~~
- Making the new member sign the LLC operating agreement
- Updating the LLC books and records as to the date of the new member's joining and his/her contribution amount

Conclusion Now that over ten years have passed since LLCs first came on the California legal scene, the management of each continuing LLC should account for its membership changes and do the paperwork that will protect the decisions that were made way back when.

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