

Monday, July 25, 2016

Multi-member LLC vs Single Member LLC

Why is the Liability Protection Greater?

A limited liability company ("LLC") provides a certain amount of liability protection that is very similar to the protection offered by a corporation. For example, Samantha buys shares in ABC, Corp.; ABC Corp goes bankrupt and Samantha loses her investment. However, as we all know, ABC's creditors cannot attach Samantha's other assets- her home, bank accounts, etc are safe from ABC's creditors. The same will hold true if instead of ABC Corp, Samantha buys shares in XYZ LLC. She will lose her investment but nothing else.

However, if the reverse happens: Samantha's assets are attached by a creditor, are the subject of a divorce action or a lawsuit, then her creditors will be able to access all of her assets including her stock in ABC Corp. If that happens, whomever ends up with the stock will receive the dividend, attend meetings and vote her stock. That would not happen if she owned the shares in XYZ LLC because of a legal theory known as "Choose your Partner." LLC law is at least partially derived from partnership law. (In fact, the NH LLC Act, RSA 304-C, is found under the title "Partnerships" along with the law on limited partnerships, general partnerships, etc). This theory is that if Samantha enters into an agreement with Bob and Ted to invest in a business venture, SBT Investments, LLC, Bob and Ted had no intention in being partners with Samantha's soon-to-be ex-husband or any other creditor. Thus, Samantha's creditors cannot take her membership in the LLC; what they can do is place a lien on any distributions from that LLC. This lien is called a charging order. The creditor may receive money originally destined for Samantha, but the creditor doesn't get to sit at the table and vote her membership rights. All of this is assuming that there are distributions to Samantha. If the LLC isn't making any distributions, the creditor does not receive anything. This concept is codified in the NH LLC Act at **RSA 304-C:126**. and that statute provides that a charging order is the sole remedy a creditor may bring against an LLC membership for debts not related to the LLC. Therefore, it can be said that an LLC offers more liability protection than a corporation because an LLC offers "two-way" liability protection while a corporation does not.

Okay, so how can this work with a single member LLC? There are no partners. However, there is no exception in most states for single member LLCs and no specific statutory protection for them either. It is assumed that single member LLCs get the same protection but there is always the risk that a court will find otherwise. The New Hampshire Act dealt with this in a manner that was hoped would clarify the issue but still give some protection to creditors. A single member LLC could not make any distribution at all but keep property that was appreciating and therefore a creditor might not ever receive anything- or at least not for a long time. RSA 304-C:126 specifically authorizes charging order protections for single member LLCs but then limits those protections to give some ability of legitimate creditors to challenge the protection if the creditor can show that the judgment cannot be satisfied in a "reasonable time." If the creditor is successful, a sale of the membership rights can be forced. See RSA 304-C:126 (VI).

For all of the reasons above, I frequently will recommend that clients wishing to form a single member LLC at least consider bringing in a spouse or an adult child for a minority interest. I usually recommend at least 18 or 19% if not a full 50%. The activities of the second member can be limited in a number of ways, including making the LLC manager-managed with the original founding member the manager. If the second member is not really going to participate much in the company, then I will try to keep the percentage ownership under 20% as that is the number at which many banks will require personal guarantees of the members. A really small percentage

such as 1% or 2% may be seen as illusory so I want to keep the number up if at all possible.

Obviously, there be be downsides to bringing in a minority member and those potential pitfalls must be thoroughly discussed with the clients and one of those pitfalls for the attorney- a trap for the unwary- is the question of "**Who is the client?**" Does the attorney represent the person who originally approached him/her, both potential members or the LLC itself? Who can the attorney represent if the "partnership" breaks up- can the attorney represent any of the parties in that case or must s/he recuse and refer to another attorney? Another question is "What effect, if any, does a divorce have on multi-member LLCs involving spouses?"

Posted by Dwight Sowerby at 12:02 PM No comments:

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