

Alberty.com - Winter 2003 Newsletter

We're sending this newsletter to you, as a customer of Alberty Publishing LLC, to bring you news about the law of limited liability companies and what's new at our Web site.

Withdrawal of an LLC Member

If a member of an LLC wants to liquidate his or her interest in order to pursue other business interests or retire, the member will often withdraw from the LLC. But there are a number of things a member needs to consider before doing so.

The first thing to consider is whether the member has the power to withdraw. Most LLC operating agreements permit withdrawal, but some prohibit it during the formative years of the LLC when members' withdrawals of their investments could hurt the LLC's business. Other operating agreements prohibit withdrawal entirely. A shareholder cannot withdraw from a corporation, so operating agreements for manager managed LLCs that are based on a corporate model of governance are particularly prone to prohibit member withdrawal.

An LLC member who lacks the power to withdraw may need to consider selling his or interest to another member or to a third party in order to liquidate the interest. But since interests in closely held LLCs are not readily marketable, the member may not receive full value from such a sale. The ability of a member to sell an interest to someone other than the LLC and the price that can be obtained may also depend the extent to which the LLC's operating agreement restricts sales of members' interests or gives the LLC or the other members a right of first refusal when such a sale is planned.

A member who owns a majority of the voting interests in the LLC may be in a position to force the LLC to purchase his or her interest, regardless of what the operating agreement says about withdrawal. But selling an interest to an LLC is an act of self-dealing, and this requires approval of a majority of the other members of the LLC.

A member with majority voting control may also be able to cause dissolution of the LLC, resulting in liquidation of the LLC's property and distribution of the proceeds to its members. Although the member's interest will be liquidated if the LLC is dissolved and a dissolution does not involve self-dealing, many LLC operating agreements require unanimous member approval for dissolution of the LLC.

If a member has the power to withdraw, consideration must be given to the consequences of doing so. Many operating agreements require the LLC to purchase a withdrawing member's interest at a price determined under the agreement and on terms specified in the agreement. If an operating agreement treats withdrawal of a member in the same way as a member's death or disability, an effort may be made in the operating agreement to insure that the price is fair and the terms reasonable. But a withdrawing member should make sure that the LLC's operating agreement does not reduce the price or extend the terms if a member withdraws voluntarily. If

the operating does so, the withdrawing member may be able to obtain a better price or more favorable terms by selling his or her interest to another member or a third party.

If a member has a right to withdraw and the price and terms for the LLC's purchase are attractive, the member needs to consider whether the LLC is able to pay the purchase price. Applicable state law generally prohibits an LLC from paying the purchase price for a member's interest if doing so would render the LLC insolvent. This restriction is important to a withdrawing member because the member may be personally responsible for liabilities of the LLC that go unpaid because LLC funds were used to purchase the member's interest.

Another issue that needs to be considered by a member contemplating withdrawal is what the tax consequences will be if the LLC purchases his or her interest. The member will often realize capital gain or loss if his or her interest is sold to the LLC. The member may realize some ordinary income under the collapsible partnership rules of IRC §751 if the LLC has inventory or unrealized receivables, but selling the interest to another member or a third party won't affect whether this income is recognized and can even increase the amount of the income if the LLC's inventory is not highly appreciated.

If the LLC is engaged in providing personal services, the LLC's purchase of a withdrawing member's interest can cause the member to recognize ordinary income under IRC §736(a). Although income is not recognized under IRC §736(a) if an LLC member's interest is sold to someone other than the LLC, other members of the LLC receive a tax benefit when an LLC purchases the interest of a withdrawing member and the member has IRC §736(a) income. The value of this benefit is often considered in setting the price for the interest of a withdrawing member under an LLC's operating agreement, and the member may realize the same amount after taxes whether the interest is sold to the LLC or to someone else.

The final issue that needs to be considered by a withdrawing member is his or her continued liability for the LLC's obligations. If the member has personally guaranteed LLC obligations or has granted security interests in the member's own property to secure these obligations, the member will want the guarantees and security interests released at the time of the withdrawal. If the creditors are unwilling to release these guarantees and security agreements, as is often the case, the withdrawing member will want indemnification agreements from the remaining LLC members. Continued liability on LLC obligations is a concern whether the LLC purchases the withdrawing member's interest or it's purchased by another member of the LLC or a third party.

Newsletter Archives

We've recently added an archive of past issues of our customer newsletter to our Web site. If you want to read articles from our past newsletters on topics like adding a new member to an LLC and tax treatment of single member LLCs, just go to www.alberty.com and click on "newsletter" at the top of the page.

New Ordering System

The system for ordering forms from our Web site has also been upgraded recently. Forms can now be downloaded at the time you place your order. You no longer have to wait for forms to be delivered to you by e-mail, making it easier and more efficient to order forms from our Web site and allowing you to get on with your drafting project faster.

If you don't have our Form 5.3, which provides for the LLC's purchase of the interest of a withdrawing member, this may be a good time to purchase the form and try our new ordering system.

Subscription Info

We'd like to continue sending you updates on the law of LLCs and about useful forms that can enhance your practice. But if you'd rather not receive our newsletters, just let us know by replying to this e-mail. A human being will read your e-mail, so just ask us to take you off our mailing list – no magic words are needed in the subject line. We don't sell our mailing list, so asking to be removed won't increase the spam you receive.

We welcome your input or feedback about this newsletter. Please feel free to reply with any thoughts or requests. Thanks.

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