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# Morphing an LLC – From Multi-Member to One Member – and Back: What Could Happen?

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Presented to:

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## I. INTRODUCTION

‘Morphing’ an LLC. What is that? Are we really talking about conversions?

No. We are talking about shifts in LLC ownership—shifts in the number of members; shifts that occur at the member level; that might occur without fanfare; or that occur due to events in a member’s life or family.

Often, shifts in ownership are due to one or more ‘transfers’ and, when discussing transfers, we must discern between a mere ‘transferable interest’ and a member’s ‘entire interest’ and between a ‘transferee’ and a ‘dissociated member’ and between a transfer of part vs. all of the interest held by the transferor.

Why? Because many rules in Utah’s LLC Act pivot on such distinctions, such as:

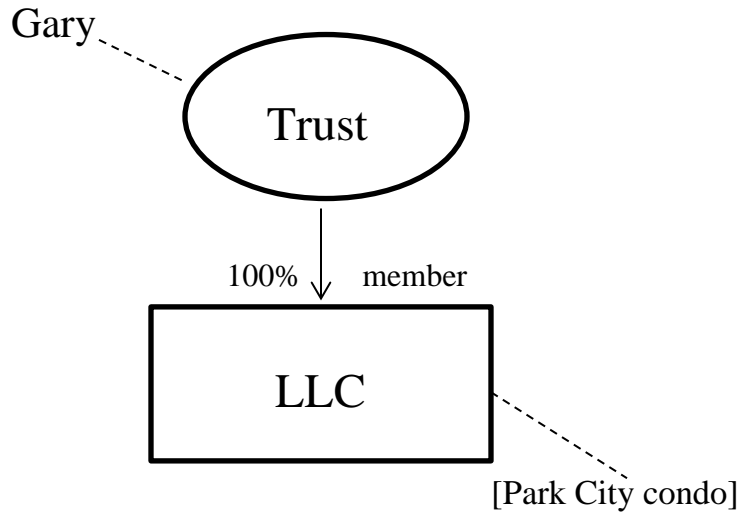
- (1) dissociation of members
- (2) voting and consent
- (3) approving major transactions
- (4) fiduciary duties—duty of care; duty of loyalty (non-compete, business opportunity, no self-dealing)
- (5) appointment and removal of managers
- (6) approving distributions
- (7) sharing distributions
- (8) rights of creditor under charging order

## II. FROM ONE MEMBER LLC TO MULTIPLE (?)

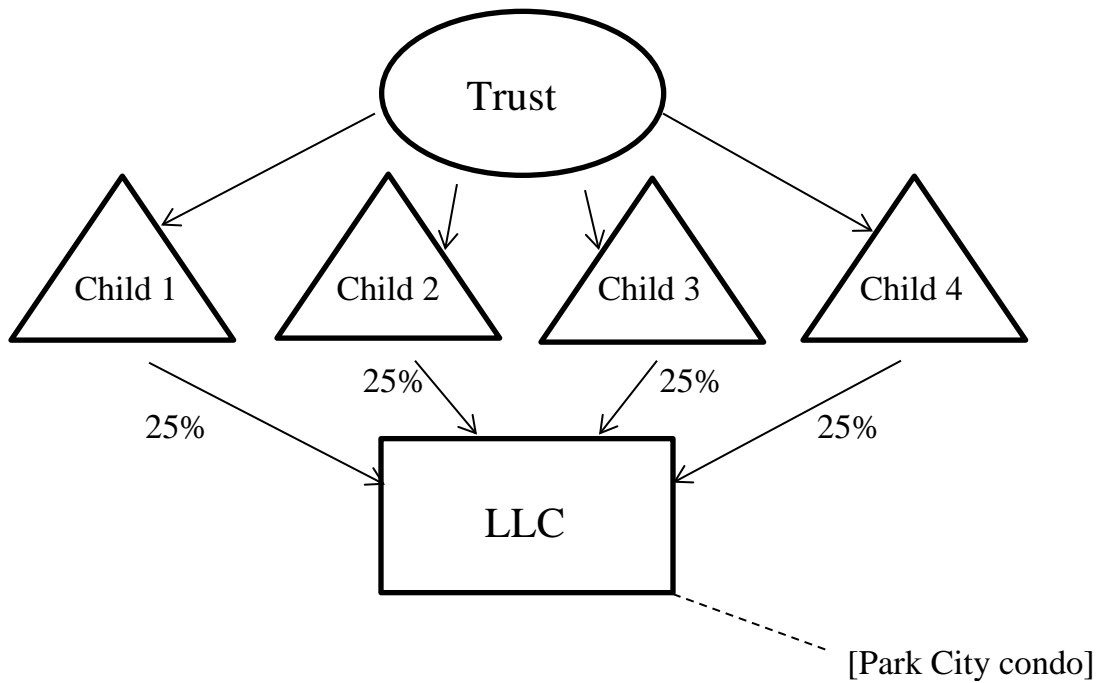
### EXAMPLE A

In doing his estate planning, Gary created a revocable living trust. Gary wanted to buy a condo in Park City to put into a rental pool and for personal use.

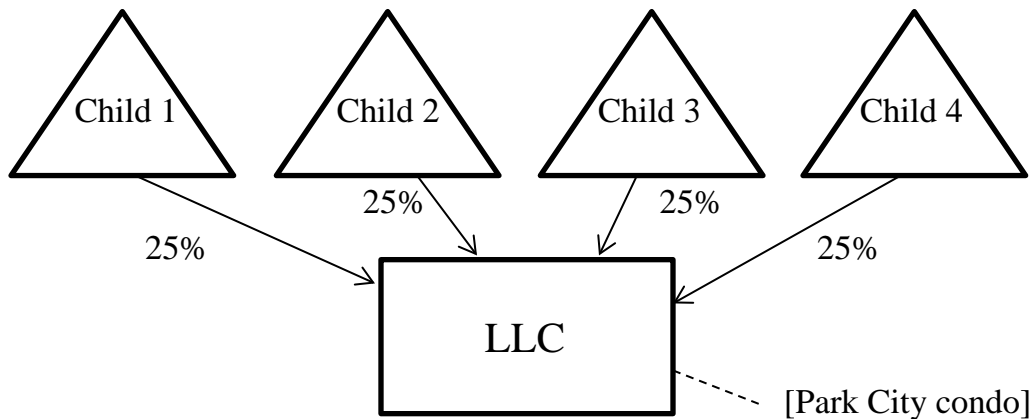
Gary’s lawyer advised him to form a 1-member LLC to own the condo with the Trust owning the LLC. All of that occurs except the LLC has no operating agreement.



Gary named his 4 adult children as death beneficiaries of his Trust. Gary dies. Per the Trust document, the Trustee distributes the LLC interest to the 4 children in equal shares:



### Result



Although the Trust distribution was completed, there was an omission -- No document was prepared or signed to say the 4 children were accepted as “substituted members” of the LLC in place of the Trust.

Six months pass. What happens?

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Quick answer: LLC dissolves and must wind up its affairs. Let’s see why.

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**Utah Code §48-3a-102(14)** defines ‘member’:

‘Member’ means a person that:

- (a) has become a member . . . under Section 48-3a-401. . .; and
- (b) has not dissociated under Section 48-3a-602.

**Utah Code §48-3a-602(9)**

A person is dissociated as a member when:

...

(9) in the case of a person that is a testamentary or *inter vivos* trust or is acting as a member by virtue of being a trustee of such a trust, the trust’s entire transferable interest in the limited liability company is distributed;

Result: Because the Trust distributed its ‘entire transferable interest’ to the 4 beneficiaries, the Trust was dissociated as a member.

Q: What is the effect of dissociation?

***Utah Code §48-3a-603. Effect of dissociation.***

*(1) If a person is dissociated as a member:*

*(a) the person’s right to participate as a member in the management and conduct of the company’s activities and affairs terminates;*

That means the Trust lost its right to vote or consent (and ceased to be a member).

Before it distributed to its beneficiaries all transferable interests in the LLC, the Trust was the sole member of the LLC. Yet, after such distribution, the Trust was no longer an LLC member [*per §48-3a-602(9)*].

Q: What about the 4 Trust beneficiaries? Are they members?

Remember: To have a valid LLC there must be at least 1 member [*§48-3a-201(4)*] and, after an LLC is formed, a person becomes a member only “. . . ***with the consent of all members.***” [*§48-3a-401(3)(c)*]

***Utah Code §48-3a-502(1)(c):***

*...a transfer, in whole or in part, of a transferable interest:*

...

*(c) does not entitle the transferee to:*

*(i) participate in the management or conduct of [LLC’s business]*

Thus, the 4 children – being transferees – have no right to vote or consent.

RESULT: At that point, the LLC had no members. Without any member to approve admission of other persons to become members, the LLC is in a “box canyon” with no way out—or so it seems. With no members, the LLC dissolves.

Although the Utah LLC Act created this dilemma, it also provides a possible solution under the “90-day rule”.

**90-DAY RULE**

***Utah Code §48-3a-701. Events causing dissolution.***

*A limited liability company is dissolved, and its activities and affairs must be wound up, upon the occurrence of any of the following:*

...

*(3) the passage of 90 consecutive days during which the limited liability company has no members unless:*

- (a) consent to admit at least one specified person as a member is given by transferees owning the rights to receive a majority of distributions as transferees at the time the consent is to be effective; and*
- (b) at least one person becomes a member in accordance with the consent;*

Utah Code §48-3a-701(3)

The 90-Day Rule could be a solution here—but only—

*IF* within 90 days after the LLC has no members:

- (a) all transferees with rights to distributions are identified; and
- (b) those transferees who own rights to receive a majority of distributions as transferees (determined at time consent is to be effective) consent to admit at least one ‘specified person’ as a member; and
- (c) at least one person becomes a member per that consent.

If prompt action is taken by the 4 children, as transferees, they could “consent” to themselves becoming members in place of the Trust and dissolution of the LLC could be avoided.

Of course, if one or more of the Trust beneficiaries is a minor, it could be difficult to timely utilize the 90-day rule. The same could be said where an estate is the sole member of the LLC, where the estate is subject to intestacy and where one or more heirs is a minor. See §48-3a-602(10).

This is one of two times in the Utah LLC Act where transferees are granted the power to vote or consent. The other time is found in §48-3a-703(4).

Transfer → Dissociation → No right to vote

Transfer → Transferees → No right to vote

Let’s look more deeply at Utah Code §48-3a-502:

<u>Defined</u>	<b><i>Utah Code §48-3a-502. Transfer of transferable interest.</i></b>
102(28)	(1) . . . <u>a transfer</u> , in whole or in part, of a <u>transferable</u>
102(29)	<u>interest</u> :
	(a) is permissible;
102(14)	(b) does not by itself cause <u>a member’s</u>
602; 701-703	<u>dissociation</u> or <u>a dissolution</u> and winding up of
[business]	<u>the limited liability company’s activities and</u>
	<u>affairs</u> ; and
102(30)	(c) . . . , does not entitle the <u>transferee</u> to:
[vote/consent]	(i) <u>participate in the management</u> or
[business]	<u>conduct of the limited liability</u>
	<u>company’s activities and affairs</u> ;
	. . .
102(4)	(2) A transferee has the right to receive, in
	accordance with the transfer, <u>distributions</u> [from the
	LLC] to which the transferor would otherwise be
	entitled.

### III. FROM MULTIPLE MEMBERS TO ONE

#### A. TAX CLASSIFICATION

1. Number of members. In Utah, an LLC must have 1 or more members. [Although Certificate of Organization is filed, LLC is not “formed” until at least one person becomes a member—§48-3a-201(4)].
2. Tax classification rules—if no contrary election is filed with the IRS, an entity formed as:
  - 2.1 A multi-member LLC is classified as a tax partnership; and
  - 2.2 A one-member LLC is classified as a ‘disregarded entity’—with all tax items reportable by its sole member.

**B. EXAMPLE B – Basic Facts: Honeybunch, LLC** was formed in 2013 (prior law) as a manager-managed Utah LLC. That management structure was elected in the original Articles of Organization as filed and as confirmed in the “Action by Members” signed at the time the LLC was organized. Honeybunch is owned 50/50 by Ed and Barbie, husband and wife, as the two members, with Ed as the sole manager.

Honeybunch owns and operates a valuable growing business. Ed and Barbie have 3 children. Neither Barbie nor any of the children participate in the business. Honeybunch has no formal operating agreement.

**C. EXAMPLE B-1** Due to divorce, Ed transfers his 50% ownership to Barbie but continues as manager. Barbie now owns 100% of the transferable interests in Honeybunch.

Q: How is that shift treated for tax purposes?

A: Honeybunch is deemed to distribute all of its assets and liabilities to Barbie--the sole owner of the LLC -- in liquidation of Honeybunch, and Honeybunch terminates.

Q: Does the IRS need to be notified of this shift?

A: Yes, because Honeybunch shifted from its original default tax classification (from rule 2.1 to rule 2.2).

Q: How to notify the IRS?

A: By filing Form 8832—which requires the name and SSN/TIN of the sole owner to be listed. [*see Form 8832, attached*].

Q: When to file Form 8832?

A: Within 75 days after effective date of event.

Q: Does Honeybunch need a new TIN?

A: No, if Honeybunch already had a TIN as a tax partnership (likely). Honeybunch keeps using the same TIN. [*see instructions for Form 8832*].

Note: In its instructions for Form 8832, the IRS treats the term ‘member’ interchangeably with the term ‘owner’ whether or not there are attached voting rights.



## IV. FAMILY IN UPHEAVAL

**A. EXAMPLE B-2** Perhaps unknowingly, Ed’s transfer of his ‘entire transferable interest’ to Barbie caused Ed to be vulnerable to being ‘dissociated’ as a member. See Utah Code §48-3-602(5)(b). Because Ed transferred his ‘entire transferable interest’, Barbie now votes to expel Ed as a member.

A basic effect of ‘dissociation’ is that the person’s right to participate *as a member* in the management and conduct of the LLC’s business terminates. Utah Code §48-3a-603(1)(a). But there’s more. Ed also lost his position as manager by reason of his dissociation as a member. Utah Code §48-3a-407(3) (e) provides, in part, that “*the dissociation of a member that is also a manager removes the person as a manager.*”

Ed didn’t see that one coming. If he had retained some interest as a member, Ed’s manager position would not have been lost.

**B. EXAMPLE B-3** Assume there was no divorce and there was no transfer from Ed to Barbie. Ed and Barbie are 50/50 owners of Honeybunch. Assume the LLC’s business continues to flourish. Barbie sets up a revocable Trust with herself as trustee and transfers her 50% LLC ownership to her Trust. And, with Ed’s consent, the Trust becomes a ‘substituted member’ in place of Barbie. Barbie is now dissociated.

Q: Any tax consequence from Barbie’s transfer to her Trust?

A: No, since everything in a revocable Trust is deemed owned by Barbie--the “grantor”. Being the person holding power to revoke, Barbie continues as the person taxable.

**C. EXAMPLE B-4** Suppose Barbie wants her children to each own an LLC interest in Honeybunch. With Ed’s consent, Barbie as trustee of her Trust distributes out of Trust a 5% transferable interest to each of their three children, leaving a 35% transferable interest in Barbie’s Trust. Assume Ed and the Trust consent to the three children’s becoming ‘substituted members’ in place of the Trust as to the 5% member interest transferred to each of them.

At that point, there would be 5 members in Honeybunch—Ed (50%), the Trust (35%) and the three children (5% each).

Next, suppose a dispute develops between Ed and the children. The children consult an attorney and are told they have the power to remove Ed as manager of Honeybunch.

Q: How can that be? The children combined hold only 15% of the economic rights in Honeybunch!

Utah Code §48-3a-407(3)(d) [*in the last sentence*] states the default rule:

***A manager may be removed at any time by the consent of a majority of the members without notice or cause.***

Utah Code §48-3a-407(3)(d) [*first sentence*] states another default rule:

***A manager may be chosen at any time by the consent of a majority of the members. .***

Thus, without notice or cause, the three children can remove Ed as the manager and appoint one of the children as the new manager.

Based on head count, a *majority of the members* will make these decisions—irrespective of the capital contributions or financial ownership in the LLC. THIS RULE IS NOT INTUITIVE!

Now watch what happens.

The new manager (a child) decides to make a very large cash distribution to the members. Again, Utah’s LLC Act provides an accommodating default rule:

***In a manager-managed [LLC], . . . any matter relating to the activities and affairs [business] of the [LLC] is decided exclusively by the manager. .***

Utah Code §48-3-407(3)(a)

Believe it or not--there’s more.

The new manager also decides that such distributions are to be allocated *per capita* among the members—not per capital contributions or financial ownership. See Utah Code §48-3a-404(1):

*Any distributions made by . . . [an LLC] before its dissolution and winding up must be in equal shares among members and persons dissociated as members except to the extent necessary to comply with a transfer effective under Section 48-3a-502 . . .*

That means the three children, as 3 of the 5 members in Honeybunch, will receive 60% of the cash distributions instead of 15% of distributions.

## V. MEMBER WITH NO SKIN IN THE GAME

Under Utah’s LLC Act, a person can become a member without having any ‘skin in the game’:

*A person may become a member without:*

- (a) *acquiring a transferable interest; or*
- (b) *making or being obligated to make a contribution to the [LLC].*

Utah Code §48-3a-401(4)

**EXAMPLE C** Father is beginning his retirement and wants to give each of his 2 sons 50% of the LLC that owns the family business. Due to Father’s vast experience and contacts with customers, the sons want Father to stay involved in the business in some capacity. They have several questions:

Q: Should Father be a member of the LLC?

- with some % ownership or with no ownership?
- with some voting rights or no voting rights?
- with some power to bind or no power to bind?
- with or without fiduciary duties?

## VI. SOME POT-HOLES IN UTAH’S LLC ACT

### A. Unanimous Consent of Members.

Where an LLC has no operating agreement, Utah’s LLC Act requires consent of **ALL Members** for the following transactions:

	Member-managed LLC	Manager-managed LLC
Admit a new member	401(3)(c)	401(3)(c)
Sell business	407(2)(d)	407(3)(c)(ii)
Major loan	407(2)(d)	407(3)(c)(ii)
Major lease	407(2)(d)	407(3)(c)(ii)
Merger	1023(1)(a)	1023(1)(a)
Conversion	1043(1)(a)	1043(1)(a)
Dissolve LLC	701(2)	701(2)
Amend Operating Agreement	407(2)(f)	407(3)(c)(iii)
Change Business Purpose	407(2)(d)	407(3)(c)(ii)

B. Retained Rights By Transferors

A member’s voting rights may or may not be retained upon a member’s transfer of a transferable interest – depending on what the other members decide.

Utah’s LLC Act attempts to say that in “statutese”:

***Utah Code §48-3a-502(7):***

...

*(7) Except as otherwise provided in Subsection 48-3a-602(5)(b), if a member transfers a transferable interest, the transferor retains the rights of a member other than the transferable interest transferred and retains all the duties and obligations of a member.*

Is that clear?

To clarify what this provision is trying to say, perhaps Section 48-3a-502(7) should be edited and re-stated to read as follows:

***Restated Utah Code §48-3a-502(7):***

*(7) Except as otherwise provided in Section 48-3a-602, if a member transfers [or is deemed to transfer] a transferable interest, the transferor retains the rights of a member [as to any transferable interest not transferred] and retains all the duties and obligations of a member [as to any transferable interest not transferred].*

Note: Any contrary views are welcome.

### C. Many Transfers Do Cause Dissociation

Many transfers—be they actual transfers, transfers by operation of law, or deemed transfers—do cause dissociation of the transferor. See §48-3a-602.

Yet, Utah Code §48-3a-502 includes the following statement:

*(1) . . . a transfer, in whole or in part, of a transferable interest:*

*. . .*

*(b) does not by itself cause a member’s dissociation or a dissolution and winding up of the limited liability company’s activities and affairs;*

That is an over-statement. Two clauses together create the error: when “*...in whole...*” is read together with “*does not by itself cause a member’s dissociation*” the meaning directly conflicts with what §48-3a-602(9) provides: that a trust distribution (transfer) of its entire transferable interest does cause the trust’s dissociation!

Best View: When a trust is the sole LLC member and distributes its entire transferable interest, that transfer causes dissociation of the Trust as a member.

## VII. TYPES OF PROVISIONS IN LLC STATUTES

### A. **Five Types of Provisions in LLC Enabling Statutes**

Utah’s LLC Act and other LLC enabling statutes typically include 5 types of provisions:

1. definitions of key terms (such as ‘organizer,’ ‘principal office,’ or ‘transfer’ as included in §48-3a-102 of Utah’s LLC Act).
2. ‘non-waivable’ rules—rules Utah’s LLC Act identifies in Section 48-3a-112(3) that cannot be varied by the LLC’s operating agreement.
3. mandatory rules—statements in the LLC statute that might be considered as ‘axioms’ or ‘constants’ that confirm certain principles for all LLCs and are not meant to be varied by the LLC’s governing

documents. Some examples of mandatory rules in Utah’s LLC Act (but that are **not** highlighted or designated in the list of ‘non-waivables’) would appear to include:

§48-3a-104(1): *A limited liability company is an entity distinct from its member or members.*

§48-3a-107: *Unless displaced by particular provisions of this chapter, the principles of law and equity supplement this chapter.*

§48-3a-112(2): *To the extent the operating agreement does not provide for a matter described in Subsection (1), this chapter governs the matter.*

§48-3a-304(2): *The failure of [an LLC] to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on a member or manager of the [LLC] for a debt. . . of the [LLC].*

§48-3a-501: *A transferable interest is personal property.*

4. default rules—rules in Utah’s LLC Act that are neither mandatory rules nor ‘non-waivable’ rules but can be varied by the LLC’s operating agreement.
5. self-enabling, permissive or prompting rules, such as §48-3a-112(4)(a):

*The operating agreement **may specify** the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested . . . persons.*

## **B. Concepts to be Covered by Default Rules in Utah’s LLC Act**

To better understand the ‘default rule’ structure, Section 48-3a-112(1) of Utah’s LLC Act states:

*Except as otherwise provided in Subsections (3) [non-waivable provisions] and (4) [permitted changes in fiduciary duties], the operating agreement governs:*

- (a) *relations among the members as members and between the members and the limited liability company;*
- (b) *the rights and duties under this chapter of a person in the capacity of manager;*
- (c) *the activities and affairs of the limited liability company and the conduct of those activities and affairs; and*
- (d) *the means and conditions for amending the operating agreement.*

These are generally referred to as the ‘internal affairs’ of an LLC.

### **C. Finding Answers to LLC Issues:**

To ascertain rules applicable to an LLC issue, one might consider searching in the following sequence:

First, the non-waivable rules in the LLC statute (§48-3a-112(3)); then

Second, the mandatory rules in the LLC statute; then

Third, the LLC’s operating agreement; then

Fourth, where the LLC operating agreement is silent or incomplete on a ‘matter’, the default rules in the LLC statute; then

Fifth, if default rules in the LLC statute don’t exist or are deficient, look to Utah case law; then

Sixth, if Utah case law does not provide the answer, look to the common law of agency or the common law of contracts or partnership law or – relevant corporate law.

## **VIII. PRACTICE TIPS**

### **A. From Multiple to One Member.**

- Prepare/adopt replacement Operating Agreement for 1 member
- Prepare and file Form 8832 with IRS [see attached Form 8832]
- Consider need for updated Certificate of Organization
- Consider need for updated Statement of Authority
- Update database at Utah Division of Corporations

**B. From One to Multiple Members.**

- Prepare/adopt replacement Operating Agreement for multiple members
- Consider need to exempt from duty of loyalty all existing or planned self-dealing transactions.
- Consider need for updated Certificate of Organization
- Consider need for updated Statement of Authority
- Update database at Utah Division of Corporations

**C. Other Suggestions**

- unless expressly covered in Operating Agreement, in document that transfers an LLC interest, include [*OR NOT*] signatures of all other members to consent that transferee becomes a ‘substituted member’ in place of transferor--as to transferred interest
- clearly define key terms: member, transferee, dissociation, transferable interest, distribution
- set voting % on key transactions at workable levels

**IX. ATTACHMENTS**

Selected Provisions of Utah’s LLC Act.....Attachment A

Form 8832 with instructions.....Attachment B