

**PART 8. FORMING SINGLE-MEMBER LLCs WHOSE MEMBERS WILL BE ENTITIES**

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**A. INTRODUCTION: SINGLE-MEMBER LLCs AS SUBSIDIARIES IN HOLDING COMPANY/OPERATING COMPANY STRUCTURES**

- 1) The main use of single-member LLCs whose members are entities. The main use of entity-owned single-member LLCs is to serve as wholly owned subsidiaries of their members in a holding company/operating company structure.
- 2) Reason for holding company/operating company structure. This holding company/operating company structure arises from the fairly obvious rule that business people should never hold valuable operating assets in operating entities, since the operations of these entities may trigger negligence claims or other claims by third parties that may result in the loss of these assets. If the plaintiffs win these claims and the operating company in question lacks adequate liability insurance, it may be forced to sell its operating assets in satisfaction of the claim.
- 3) Holding company/operating company structures—overview. Thus, many business entities that own valuable operating assets but that operate through a single entity should restructure themselves to have holding company/operating company structures. Under these structures:
  - a) They become passive holding companies;
  - b) They use subsidiaries to conduct all of their operations that could trigger third-party claims; and
  - c) They lease, license, or lend these assets to these subsidiaries.
- 4) Under the above structure, if the operating companies conduct activities that result in third-party claims:
- 5) The holding companies, because they are passive, will be immune from these claims; and
- 6) While the operating companies obviously should have commercially reasonable insurance from which to satisfy the claims, they cannot lose any assets because of the claims, since they own no assets.

## **B. SINGLE-SHAREHOLDER CORPORATIONS VS. SINGLE-MEMBER LLCs**

To conduct their operations, holding companies may use either single-shareholder corporations or single-member LLCs. In general, they should use single-member LLCs, since:

- 1) The management structure of single-member LLCs is much simpler and more flexible than that of corporations and requires much less in the way of legal administration; and
- 2) Single-member LLCs can be taxable as disregarded entities. Single-shareholder corporations may not.

## **C. MANAGEMENT STRUCTURES AVAILABLE TO SINGLE-MEMBER LLC OPERATING COMPANIES**

The principal legal issue you should address in forming single-member LLC operating companies for business entity clients is the issue of their management structure.

- 1) Holding companies shouldn't be managers of their operating companies. Holding companies that are members of single-member LLC operating companies should not themselves be the managers of these operating companies, since this will increase the risk of holding company liability for claims against operating companies.
- 2) Non-member manager structures. Rather, their single-member LLCs should have one of the following management structures:
  - a) In small single-member LLCs, management by a single manager or officer;
  - b) In all other single-member LLCs, management by two or more officers.
- 3) Board structures. Although I know of several single-member LLC operating companies that are managed by boards of directors and officers in a corporate management structure, this structure is, in my view, far too administratively cumbersome for most or all such operating companies.

## **D. SISTER COMPANIES VS. SINGLE-MEMBER LLCs**

In deciding whether to use a single-member LLC as an operating company subsidiary of a business entity, you should always address the question whether the operating company should instead be a sister company—that is, a company with the same ownership structure as the holding company. The main considerations making this choice are these:

- 1) Single-member LLCs are generally easier to administrate.
- 2) However, sister companies may often be less subject to veil-piercing.

## **E. AVOIDING VEIL-PIERCING IN HOLDING COMPANY/OPERATING COMPANY STRUCTURES THROUGH THE USE OF ARM'S-LENGTH INTERCOMPANY AGREEMENTS**

- 1) Types of holding company/operating company intercompany agreements. In order to avoid veil-piercing, holding companies and their single-member LLCs should, of course, maintain separate bank accounts and separate books and records. However,

in addition, all of the arrangements between the two companies should be formalized in intercompany agreements with arm's-length terms. These agreements may include:

- a) Lease agreements under which the holding company leases its real and personal property—including, for example, tools, vehicles and equipment—to the operating company;
  - b) License agreements under which the holding company licenses its name and its other intellectual property, including patents, trademarks, copyrights and trade secrets, to its operating company;
  - c) Loan agreements under which the holding company lends the operating company the operating cash it needs to cover operating expenses not covered by operating company sales of products or services;
  - d) Administrative service agreements under which the holding company provides accounting, financial and other “back-office” services to the operating company;
  - e) Marketing and sales agreements; and
  - f) Security agreements (see discussion immediately below).
- 2) Operating companies should generally own the products they manufacture for their holding companies. Since defective products can lead to substantial product liability claims, operating companies in holding company/operating company structures should generally own the products they sell and any materials they use in manufacturing them. However, in many cases their holding companies should lend them the cash to purchase or manufacture assets and should set them up as collateral for these loans under formal security agreements and file UCC-1s to obtain first-position security interests in them.

#### **F. WHAT ENTITIES SHOULD *NOT* USE HOLDING COMPANY/OPERATING COMPANY STRUCTURES?**

Even if an entity has valuable operating assets, it should not use a holding company/operating company structure if its members and managers:

- 1) Are unwilling to pay the significant legal fees necessary to set it up or
- 2) Don't want the relative complexity of the structure; or
- 3) Are unlikely to effectively implement and maintain it.