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ALERT! AZ BUSINESS LLC OWNERS

It is not my nature to be alarmist but you need to read this!

UNDER AZ'S NEW LLC ACT IT DOESN'T MATTER IF YOU OWN 80% OF THE COMPANY, AND TWO OTHER MEMBERS EACH OWN 10%, THE PROFITS ARE DIVIDED EQUALLY, 33% EACH

Equal Profits Regardless of Percentage Ownership

Under the Act, unless the operating agreement says differently, no matter what the amount or percentage of your investment, distributions and profits are equal.

If you invest 80% of the start-up capital in an LLC you expect to get 80% of the profits, right? Wrong, under the new Act you divide everything equally unless you change the rule in your operating agreement.[i] With three members you could invest $80,000 out of the total $100,000 invested in an LLC and receive only 33% of the profits.

Percentage Majority Rules, not Person Majority

Say there are two minority members holding 10% each. Under the old LLC Act the default rule was *per capita* voting; that is one person one vote. The new Act changes the rule to percentage voting where the majority percentage rules on virtually every issue.[ii] This may be more equitable for the majority investor, but it changes the rules of the game midstream for the minority owners.[iii] If you currently have no operating agreement or one which does not specify percentage voting, percentage voting will be the rule as a matter of law. This could completely erase the power and influence of minority owners.

The Statutes

Here are the statutory rules:

Distributions:[iv] Arizona Revised Statute (ARS) £ 29-3404.A states that, absent an operating agreement to the contrary: Any distribution made by a limited liability company before its dissolution and winding up must be in equal shares among members and persons dissociated as members

Voting: Per ARS £ 29-3407. 3. Except as otherwise provided in this chapter, a majority in interest of the members shall decide matters that are outside the ordinary course of the company's activities and affairs but *within the company's purpose*.[v]

An Example

To see how insane[vi] and unfair an equal distribution of profits is, consider this example: Joe contributes $80,000 of the $100,000 LLC start-up capital. Ted and Susan each contribute $10,000. The company earned $100,000 for the year. Under the new Act, if there is no operating agreement, or if the agreement does not specify percentage distributions, Joe would get 33% of

the profits, i.e. $33,000, and Ted and Susan as 20% owners would get $67,000! On this example the minority more than three times the amount they contributed – a 300% return the first year! Meanwhile, Joe would get less than half of his $80,000 contribution.

And, the same rule applies upon distribution of the proceeds of an estate.

Estate Planning:

Consider how this affects estate planning. What happens upon death? The 80% heirs get only 33% of the profits or proceeds from dissolution of the company. The minority owners get and keep most of the money. This greatly reduces both the income and value of the inherited interest.

Effect on Start Ups

The bottom-line question is: As an investment, why would anyone be the $80,000 investor if he/she could do just as well investing $10,000 in an LLC with no operating agreement? Control of the company as the majority percentage owner would have to be more important than financial return. Typically, an investor in a start-up or small company would want both.

What to Do

For all LLC Members: Have a new operating agreement that complies with the new Act and discuss other provisions of the Act with your attorney.

For the Prime Investor: If you are the majority investor be sure to have an operating agreement under which your profits and votes are based on your "Percentage interest." It is not an exaggeration to say that for the unsuspecting business owner the effects of the new statute can be life-altering!

Endnotes below

Footnotes and endnotes are awful to read but you can learn a lot about LLC's very quickly just by reading the endnotes below.

[i] The operating agreement trumps the statute's default provisions.

[ii] Change of Articles, or change to manger-managed, or vice versa, and new members require unanimous consent.

[iii] I had a Dairy Queen case where per capita voting protected the nephews against an over-controlling Aunt with the larger percentage interest.

[iv] "Distributions" are the actual payments of monies or property to the members. This includes not only the payment of profits but the division of property before, or more typically, as part of dissolution.

[v] This addition provides the majority percentage members power over things like borrowing money or pledging company assets which they did not clearly have before.

[vi] "Insane" is a legal term which means not a good idea.