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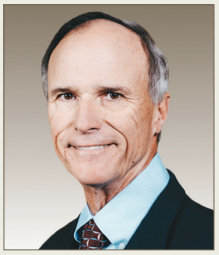
Belan K. Wagner

Should You or Shouldn't You Dissolve an LLC When the Business Is Over?

Belan K. Wagner and Matthew D. Carlson

As is the case for most legal questions, whether to dissolve or maintain the existence of an LLC once the business is over is a balancing act. Belan K. Wagner and Matthew D. Carlson explore the factors on both sides of the State Bar.

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Matthew D. Carlson

Our Picks for Top Recent Business Law Cases

We do the work for you: Here are the significant recent business law cases, with expert commentary on the most important ones.

- **The terms of a prepetition employment contract that was rejected by the bankruptcy trustee were not presumptive as to the value of an executive's postpetition services.**
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- **A disclosure form authorizing an employer to obtain a job applicant's consumer credit report violated both the federal Fair Credit Reporting Act and California's Investigative Consumer Reporting Agencies Act, because it included extraneous information about other state disclosure requirements and combined federal and state disclosures.**
  Gilberg v California Check Cashing Stores, LLC. ..... *Page 107*
- **The Leahy-Smith America Invents Act bars a person from receiving a patent on an invention that was "in public use, on sale, or otherwise available to the public before the effective filing date of the claimed invention." This includes inventions sold or offered for sale even when the details of the invention are not made available to the public.**
  Helsinn Healthcare S.A. v Teva Pharms. USA, Inc. ..... *Page 102*
- **The "transfer" of an ordinary check does not occur until the check is honored by the debtor's bank.**
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- **A pizza restaurant was required to make its website accessible to individuals with disabilities, as required by the Americans with Disabilities Act, despite the DOJ's failure to provide regulatory guidance since at least 2010.**
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EXPERT'S TAKE


M. Danton Richardson

In *Fourth Estate Pub. Benefit Corp. v Wall-Street.com, LLC,* the U.S. Supreme Court unanimously settled a split in the circuits by confirming that the language of §411(a) of the Copyright Act means exactly what it says: Absent certain limited exceptions, registration is a prerequisite for filing an action for infringement. Clarity is a good thing, but the decision does have some downsides for copyright owners. M. Danton Richardson comments. >> See *Page 100*

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FEATURED ARTICLES

Should You or Shouldn't You Dissolve an LLC When the Business Is Over?

Belan K. Wagner and Matthew D. Carlson

Introduction

One of the most frequently asked questions we encounter in our practice is whether a limited liability company (LLC) should be dissolved once the business is over. Clients usually want to avoid the necessity of paying the minimum franchise tax of $800 in California, filing tax returns showing "no activity," and filing the annual reports for an entity that is no longer conducting business. All told, these costs can run a couple of thousand dollars a year; if the client fails to fulfill these obligations, penalties abound. Although the owners of the LLC are not usually personally liable for the penalties and interest, if the LLC fails to fulfill these obligations but later has to be reactivated because it is sued or there is some unfinished business that was not known on the date of dissolution, the penalties and interest can be daunting.

As is the case for most legal questions, whether to dissolve or maintain the existence of an LLC once the business is over is a balancing act. If the client is absolutely sure that no potential liabilities will crop up in the future and absolutely sure that all business is finished, then, by all means, dissolve the entity. The problem with this approach is that "absolutely sure" means just that. In most cases, a potential for residual liabilities exists: Employment claims, employment tax claims, third party lawsuits, and other claims may arise postdissolution.

Liabilities on Distribution

So, what happens if you dissolve an LLC and distribute its assets to the members? Under Corp C §17707.07(a), the members can be sued "to the extent of the limited liability company assets distributed to them upon dissolution of the limited liability company." In general, all causes of action against a member of a dissolved limited liability company arising under this section are extinguished unless the claimant commences an enforcement proceeding against that member before the earlier of (1) the expiration of the statute of limitations applicable to the cause of action or (2) 4 years after the effective date of the dissolution of the limited liability company. Corp C §17707.07(b). This seems relatively straightforward, but when one studies the statute, things become complicated.

One of the issues that is unclear is what company assets are distributed to the members on dissolution. How long a look-back period is there? Certainly, if there is a series of liquidating distributions, the language in the dissolution and

winding-up agreement should capture all of those distributions. But what is the test to determine if the assets are distributed in liquidation or are just normal operating distributions? Federal tax law has tackled the issue of defining partial liquidations in a number of scenarios (see, *e.g.,* IRC §355) with murky success. There is certainly a point at which distributions are "old and cold," but that issue simply hasn't been addressed yet.

What has been addressed is to what extent a member can be held responsible for the LLC's debts. The statute clearly provides for a right of indemnity to the extent that a member has to disgorge more than that member received as a liquidating distribution. Corp C §17707.07(a)(1)(B). But what if one of the members is insolvent or is a limited liability entity with no money left?

Consider the following hypothetical: A, B, and C own Devco LLC. Devco LLC was in the development business and only did one project. Devco LLC made $3 million and distributed $1 million to each of the members. A, the prudent one, invested her money. B and C lived it up and went broke. Devco LLC was sued 3 years later for construction defects and a $2 million award was rendered against Devco LLC. A, B, and C were individually joined in the action. How much can be collected against A?

Civil Code §1431 provides that "[a]n obligation imposed upon several persons … is presumed to be joint, and not several." This section has been applied to liability under former Corp C §17707.07. So the answer is that the plaintiffs in the above hypothetical can recover against A for the entire $2 million and it is then up to A to collect from B and C. Further, Corp C §17701.10(c)(8) does not permit the members to modify this liability in any fashion through the LLC's operating agreement.

What happens if you don't dissolve the LLC? It would seem that rather than Corp C §17707.07 being applicable, Corp C §§17704.05 and 17704.06 would apply. These sections have some hurdles for a plaintiff to collect against a member of an LLC that maintains its existence, assuming that no third party liability remedies are available to creditors, such as voidable transfer, fraudulent transfer, successor in interest, or piercing the corporate veil/alter ego theories. Corporations Code §17704.05 provides as follows:

> **Prohibition against distribution; indebtedness to member**
>
> (a) A limited liability company shall not make a distribution if after the distribution either of the following applies:
>
> (1) The limited liability company would not be able to pay its debts as they become due in the ordinary courses of the limited liability company's activities.
>
> (2) The limited liability company's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the limited liability company were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of members whose preferential rights are superior to those of persons receiving the distribution.

Under Corp C §17704.05(a)(1), the plaintiff must show that the distribution resulted in the LLC not being able to pay its debts as they came due. This implies that you have to look at the facts and circumstances and determine whether distributions were made in excess of reasonable business reserves established to pay contingent liabilities. Section 17704.05(a)(2) provides for a hypothetical liquidation test to determine if the distribution resulted in the LLC being unable to pay its liabilities and any members with preferential distribution rights as "if" the LLC had been dissolved and liquidated at the time of the distribution.

Sections 17704.05(b)–(g) detail the accounting rules used to determine if a distribution violates the standards set forth in Corp C §17704.05(a)(1) or §17704.05(a)(2).

Section 17704.06(a) requires a manager or member to consent to the illegal distribution before being held liable under Corp C §17704.05. Section 17704.06(a) states that the amount of the liability is limited to the amount of the distribution that exceeds the amount that could have legally been distributed. The wording of this subsection implies that the liability would be joint and several as to all consenting managers or members under CC §1431.

Under Corp C §17704.06(c), a person can be held liable if that person knew that the distribution violated Corp C §17704.05, even if that person did not consent to the distribution. To the extent that there is liability for distributions from an LLC under Corp C §17704.06(c) that "remains alive," it is not clear that, under CC §1431, there will be joint or several liability. Section 17704.06(c) seems to specifically limit liability to the amount received by a person in excess of the amount that could be legally distributed.

Tax Liabilities

When tax liabilities are among the potential residual liabilities, additional care must be exercised in ascertaining the possible exposure due to the complex provisions contained in both the federal tax assessment and tax collection statutes of limitation. Most multi-member LLCs are taxed as partnerships, so historically an LLC would not have had much ongoing income tax exposure unless it elected to be taxed as a C corporation. Unless the LLC opts out as a small partnership, the new federal centralized partnership audit rules provide for tax assessment and collection at the partnership level. When an LLC is unable to pay a tax assessment, *e.g.,* because it is dissolved, the IRS may also assess the members according to their proportionate shares. However, Corp C §17707.07(a) represents an opportunity for the IRS to pursue tax collection from members in excess of their proportionate shares in the context of dissolved LLCs. While normally the IRS may only collect assessments from LLC members according to their proportionate shares via partner-level assessments, when an LLC has been dissolved and its assets distributed to the LLC members, §17707.07(a) pro-

vides for joint liability for the LLC members for the entire LLC liability, even when such liability exceeds a member's proportionate interest or amount received on liquidation. Thus, under the new centralized partnership audit regime, it is possible that the IRS will pursue collection of partnership-level assessments from LLC members in excess of their proportionate shares.

It should also be noted that when the IRS is a potential creditor, state statutes of limitations are inapplicable. *Bresson v Commissioner* (9th Cir 2000) 213 F3d 1173, 1175; see also *U.S. v Summerlin* (1940) 310 US 414, 416, 60 S Ct 1019 ("It is well settled that the United States is not bound by state statutes of limitation or subject to the defense of laches in enforcing its rights."). Accordingly, the normal 4-year period from the date of dissolution may not be the end of the story.

Concluding Advice

Tell your client not to be penny wise and pound foolish. Keep a reasonable reserve in an LLC that has wrapped up business and keep it alive for 4 years. Further, where there is potential tax exposure, a closer examination of the facts and circumstances is warranted in determining how long to keep the LLC active, because there are several exceptions to the normal 3-year federal statutes of limitation for assessment.