

PART 3. THE LLC FORMATION PROCESS--OVERVIEW

OVERVIEW

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EXHIBIT 3-1 LLC Formation Checklist

A. STARTING AN LLC FORMATION PRACTICE

- 1) Let’s assume that you’ve never formed an LLC but that you’d like to learn to do so—and let’s assume that you’d like to do so in accordance with best practices.
- 2) In order to get started, you need to ask yourself three main questions:
 - a) What are the *key steps* in the LLC formation process? Once you know all these steps, you can systematically master each of them.
 - b) What *knowledge* do you need to handle the process?
 - c) What *practice tools* do you need in order to handle the process?

B. THE KEY STEPS IN THE LLC FORMATION PROCESS

- 1) Exhibit 3-1 —the 35 tasks.
 - a) Creating a comprehensive list of tasks. In writing *Drafting Limited Liability Company Operating Agreements*, I’ve devoted much time and effort to the development of a complete checklist of the tasks that lawyers should perform if they want to provide their clients with comprehensive LLC formation services. The results of my efforts are set forth in Exhibit 3-1.
 - i) The 35 tasks. Exhibit 3-1 lists 35 main LLC formation tasks, of which eight are federal and state tax tasks and 27 are non-tax tasks—consisting mainly of tasks involving business organization law issues. Exhibit 3-1 is the backbone of *Drafting Limited Liability Company Operating Agreements*, and it is the backbone of this seminar.
 - (1) Attendee review of Exhibit 1-1. I hope that the contents of Exhibit 1-1 are self-explanatory, so I won’t go over them here. However, I urge you to review the exhibit when you get a chance, and if you find any tasks in them whose nature is unclear to you, please let me know and I’ll try to explain them to you.
 - ii) Use of Exhibit 1-1 as a best practice. Indeed, in my view, the most basic best

practice in LLC formation practice is to acquire or create a master checklist like Exhibit 3-1.

- iii) Exhibit 1-1 and complexity. As I noted in Part I, the provision of comprehensive LLC formation services to clients in accordance with best practices is irreducibly complex, and many of the tax and non-tax tasks are themselves quite complicated. For example:
 - (1) Task 3—handling professional conduct issues. Task 3 consists of handling professional conduct issues in LLC formations. As we'll see in Part X of this seminar, there are 11 main professional conduct issues. Each of them—such as handling joint representations in LLC formations, can be complex and tricky.
 - (2) Task 8—choosing the right governing LLC act. Task 8 consists of choosing the governing LLC act in an LLC formation. In the case of a high-stakes LLC, a complex analysis may be necessary in order to choose correctly between the New Act and, say, the Delaware Limited Liability Company Act.
 - (3) Task 15—handling fiduciary issues. Task 15 consists of handling fiduciary issues in LLC formations. The chapter in my book about how to handle fiduciary issues is 109 pages long and addresses the handling of many dozens of fiduciary issues.
- b) Paring down Exhibit 3-1. Is it really possible that in order to provide comprehensive LLC formation services to a client, you need to perform no fewer 35 tasks? At first blush, the number seems much too high. So I've asked many lawyers whom I view as fine LLC lawyers to tell me if I should strike anything from Exhibit 3-1. But so far, they've always said no.
- 2) The four key tasks. However, I'm happy to say that Exhibit 3-1 can be boiled down to just four *key* tasks—namely, issue identification, issue resolution, negotiation of the LLC, and drafting the LLC operating agreement.
 - a) Issue identification. When you work with clients to form LLCs, your first job is to identify with them all the LLC business organization law issues, tax issues and other issues relevant to them. As I'll discuss in greater detail later in this seminar, the key for doing so is to select the right model operating agreement for the client and to use its table of contents as an issues checklist.
 - b) Issue resolution. You must, with the client, develop resolutions for each of these issues that will be in the client's best interest. Again, a good model operating agreement will greatly facilitate this task. It should provide you with optimal starting points for resolving these issues. I'll discuss operating agreements and model operating agreements in, respectively, Parts 5 and 6 of this outline.
 - c) Negotiation. In the case of multi-member LLCs, your clients may want you to help them negotiate the terms of the LLC deal with the other parties. Indeed, even the formation of single-member LLCs may involve negotiations with prospective single-member LLC managers or assistant managers.

- d) Drafting of operating agreement. You must draft an operating agreement that formalizes the results of the above steps. Here, too, the key is a good model operating agreement. Drafting operating agreements is often an easy job; the hard job is planning and negotiating the agreement.

C. WHAT KNOWLEDGE DO YOU NEED IN ORDER TO HANDLE THE LLC FORMATION PRACTICE IN ACCORDANCE WITH BEST PRACTICES?

In order to handle LLC formation practice under the New Act in accordance with best practices, you need four main types of knowledge:

- 1) Knowledge of LLC formation tasks. You need to identify and master each of the tasks involved in handling LLC formations—which, in broad overview, we’ve just discussed.
- 2) Knowledge of the New Act. You need to know the New Act from an LLC formation viewpoint. We’ll discuss the issue of what it means to understand the New Act from an LLC formation viewpoint in Part 3(D) of this Outline, and I’ll discuss various key features of the New Act itself in Part 4 of the Outline.
- 3) Knowledge of LLC tax. If you’re a tax lawyer, you need knowledge of LLC tax—but, as I’ve noted, I won’t discuss LLC tax in this seminar.
 - a) You don’t need to know LLC tax to be a first-rate LLC lawyer. However:
 - i) Possessing this know makes LLC formation practice much more challenging and rewarding, and
 - ii) Knowing how LLC law and tax interact in an LLC formation can be of major benefit to one’s LLC formation clients.

In short, if you want to be a really fine LLC formation lawyer, you should learn as much as you can not only about LLC business organization law but also about LLC tax.

- 4) Knowledge of Utah LLC case law as such and of Utah non-LLC cases relevant to Utah LLC formations.
 - a) If you’re forming a Delaware LLC, you absolutely must have a detailed understanding of a famous Delaware Supreme Court LLC case called *Elf Atochem North America, Inc. v. Jaffari*, 727 A.2d 286 (Del. 1999). Is there any *Elf Atochem* case in Utah LLC law?
 - b) Regrettably, we won’t have time to discuss this case law during this seminar. However, my very quick Westlaw review of the 57 cases that involve §§ 48-2b and 2c (the two “old” Utah LLC acts) suggests to me that none of these cases is indispensable to Utah LLC formations. Would anyone care to differ?

D. WHAT DOES IT MEAN TO “KNOW” THE NEW ACT FOR LLC FORMATION PURPOSES?

- 1) Obviously, you cannot be said to be competent in forming Utah LLCs unless you have a solid basic knowledge of the New Act from an LLC formation viewpoint. In

order to gain this knowledge, you need to do the following:

- a) Identification of the relevant New Act provisions. You need to identify and understand each of the provisions of the New Act potentially relevant to LLC formations. These don't include, for example, Division of Corporations house-keeping provisions and provisions governing non-Utah LLCs. By my count, however, they do include at least 250 New Act provisions. These include, for example,
 - i) Provisions about the completion and filing of articles of organization; and
 - ii) Provisions about financial issues, dissociation issues, membership transfer and redemption issues, management issues, fiduciary issues, dissolution issues, and dispute resolution issues.
- b) Proper characterization and use using each relevant provision.
 - i) Introduction—the five types of LLC statutory provisions. Most or all of the provisions of any LLC act, including those of the New Act, can be classified for LLC formation purposes in one of five statutory classifications on the basis of their statutory functions (as opposed to their subject matter). The statutory classification of a provision determines its tactical significance in planning and negotiating LLC deals. Set forth below are definitions of the five classes of statutory provisions, examples of each, and illustrations of how to use each type of provision in handling LLC formations:
 - ii) Definitional provisions.
 - (1) Definition. Definitional provisions are those that define terms used in the act.
 - (2) Example and use.
 - (a) Under Section 102(28), “transferable interest” means, in general, “the right of a member to receive distributions in accordance with the operating agreement.” Under Section 102(28), “transferable interest” does not include the right to receive allocations of LLC profits and losses; indeed, the New Act does not even provide for allocations.
 - (b) Obviously, you need to understand the narrowness of the term “transferable interest,” you need to know that it does not cover allocations, and you need to construe other provisions of the New Act, such as its charging order provisions, and to plan and draft operating agreements under the New Act accordingly.
 - iii) Mandatory provisions.
 - (1) Definition. Mandatory provisions are provisions in the New Act that the Act does not permit LLC members to validly override in their operating agreements.
 - (2) Example and discussion. Section 112(3)(k), a mandatory provision, arguably provides (though the matter is somewhat unclear) that operating agreements may not override the right of members under the New Act to

bring direct actions in court to challenge certain types of misconduct by other members and by managers. If you are unaware of Section 112(3), you may make the mistake of providing in an operating agreement that the exclusive procedures for resolving LLC disputes is arbitration. This mistake may someday cause injury to a client you represent in forming the LLC.

iv) Default provisions.

- (1) Definition. Default provisions are those that the New Act *does* permit members to validly override in their operating agreements.
- (2) Example and discussion. Section 407(b) is a default rule that provides, in effect, that each member shall have one vote on each matter that members may decide by vote. If your client is making a significant contribution to an LLC and wants his voting power to be proportional to his share of contributions, you must seek to override Section 407(b) in the operating agreement. If your client wants the one-member/one-vote rule to govern the LLC, you may want to avoid even raising the member voting power issue in negotiating an LLC deal.

v) Self-enabling permissive provisions.

- (1) Definition. Self-enabling permissive provisions are those that permit LLCs, their members or their managers to take specified actions *without* authorization in their operating agreements. Self-enabling permissive provisions usually state that “a limited liability company *may*” take a specified action.
- (2) Example and discussion.
 - (a) Section 408(2) provides that “a limited liability company may advance” reasonable litigation costs to members and others. Under the terms of Section 408(3), it would appear that such an advancement can be provided by majority vote of the members or managers even in the absence of any enabling terms in the operating agreement.
 - (b) If your client in an LLC formation under the New Act wants to facilitate these indemnifications, you should probably be silent about them during the negotiation of the operating agreement. If your client wants to prevent these indemnifications, you must seek to override Section 408(2) in the operating agreement.

vi) Non-self-enabling permissive provisions.

- (1) Definition. Non-self-enabling permissive provisions are those that specify particular types of actions that LLCs, their members and their managers may take, but only *with* authorization in their operating agreements. Non-self-enabling provisions usually state that “*the operating agreement may provide*” for specified actions.

(2) Example and discussion.

(a) Section 112(4)(a) provides, in general, that “the operating agreement” may specify the method by which a specific action that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons.

(b) If it is in the best interest of a client of yours in an LLC formation under the New Act to facilitate at some point in the future his being able to obtain such an authorization under Section 112(4)(a), you must ensure that the method of authorization is specified in the operating agreement. If your client wants to avoid any such authorization, you should seek to avoid discussion of the issue during the negotiation of the operating agreement.

2) The need for a master list and five sub-lists.

a) Very few lawyers can memorize all of the types of information about the New Act outlined above. Instead:

- i) You must prepare a master list of all of the 250 or so relevant provisions;
- ii) You must properly characterize each of these provisions in one of the five categories listed above;
- iii) You must break out your master list into five sub-lists in accordance with these categories; and
- iv) If you wish to give comprehensive LLC formation services to your clients, you must consult these sub-lists in each such formation.

The object tasks are very challenging and time-consuming. However, if you don't have the above lists, you will be unable to perform several key LLC formation best practices.

3) Knowledge of Utah LLC case law. As we've discussed above, you need to be familiar with all Utah cases potentially relevant to LLC formations.

4) LLC business organization law and tax law issues. You need to know all of the principal business organization law issues (and, if you are a tax lawyer, the tax issues) that you should address with your client in forming single-member and multi-member LLCs.

5) Practice tools. Among the principal practice tools you need in order to handle Utah LLC formations competently are:

- a) As indicated, a comprehensive LLC formation checklist;
- b) A list that sets forth of all of the New Act provisions relevant to LLC formations and the proper statutory classification of each; and
- c) Lists of the substantive issues likely to be significant all of the various basic types of single-member and multi-member LLCs.

As discussed above, the summary and detailed tables of contents of sound operating agreements can serve well as lists for the above purposes.

E. WHAT PRACTICE TOOLS DO YOU NEED IN ORDER TO BE WELL EQUIPPED FOR AN LLC FORMATION PRACTICE?

Few lawyers can carry around in their heads all of the knowledge they need in order to provide their clients with comprehensive LLC formations in accordance with best practices; to provide these services, they need a wide variety of practice tools. In my view, you need two main types of practice tools in order to be well equipped for an LLC formation practice:

- 1) Checklists. In order to avoid missing any significant steps in the various LLC formation tasks you perform, you need a wide variety of practice checklists. As discussed above, the most important of these is, in my view, an LLC formation checklist such as that contained in Exhibit 3-1.
- 2) Forms. New Hampshire lawyers sometimes ask me if I can give them a copy of my “LLC form.” The question makes no sense, because you need four distinct kinds of LLC forms to form LLCs in accordance with best practices—namely:
 - a) General-purpose model operating agreements. You need general-purpose model operating agreements—i.e., forms not designed for specialized LLCs such as husband-wife LLCs, series LLCs, corporate joint ventures and estate planning LLCs for the consolidation and management and protection of family assets. In Part 6, I’ll discuss what constitutes a good general-purpose model operating agreement.
 - b) Special-purpose model operating agreements. As indicated, you need *special-purpose* model operating agreements for specialized types of LLCs.
 - c) Plug-in provisions. You need plug-in provisions. Plug-in provisions are those that are necessary to supplement or replace the “standard” provisions in your model operating agreements when the standard provisions in them won’t work for your clients. Examples are:
 - i) “Texas shoot-out” provisions to resolve disputes between the members of two-member LLCs;
 - ii) Right-of-first-offer and right-of-first-refusal provisions;
 - iii) Tag-along and drag-along provisions; and
 - iv) Manager indemnification provisions.
 - d) Tax forms. If you are competent to handle LLC tax issues, you need a variety of specialized tax plug-in provisions—for example, to cover contributions of property under IRC § 704(c)(1)(A) and to enable members to avoid Social Security Taxes on their shares of LLC income under Prop. Reg. § 1.1402(a)-2.