PART 4. THE NEW ACT—INTRODUCTION AND EVALUATION

OVERVIEW

EXHIBIT

A. INTRODUCTION; BRIEF HISTORY OF LLC LEGISLATION IN UTAH; UTAH ENTITY FORMATION STATISTICS

1) Part 4 of the seminar—overview. For the next sixty minutes, I will focus on Utah's new LLC Act. During this time:

   a) I'll provide a brief overview of the Act;

   b) I'll identify and briefly discuss what I believe to be the factual considerations and the public policies that should underlie the New Act; and

   c) I'll identify what I believe are the major pitfalls in the New Act and I'll give my views as to how to deal with them.

2) History of Utah LLC legislation.

   a) The existing Utah LLC Act (the "Old Act") was enacted in 1991 and replaced by an act enacted in 2001 (the "Current Act").

   b) On January 1, 2013, the New Act came into law. It is codified as § 48-3a-101 et seq.

   c) Under New Act, Section 1405, the New Act will become effective on January 1, 2014 with regard to Utah LLCs ("Old Act LLCs") formed on and after that date.

   d) In general, the New Act will be become effective as to Old Act LLCs on January 1, 2016. However, Section 1405 provides that Old Act LLCs may elect, by amending their operating agreements, to be covered by the New Act before January 1, 2016.

3) LLCs as the entities of choice in Utah.

   a) As demonstrated in Exhibit 1-1, LLCs are now by a wide margin the entities of choice for Utah business start-ups. There are now about 156,000 Utah LLCs as compared with only 75,000 Utah business corporations, and thus far during the current year, about 9,000 Utah LLCs have been formed as compared with only 1,763 business corporations—a ratio of more than five to one.

   b) Thus, even more now than before April 1, 2013, you can't be a good Utah business lawyer unless you have a solid knowledge of Utah statutory LLC law and of how to form Utah LLCs.

4) RULLCA as the basis for the New Act. The New Act is based to a substantial degree on the Revised Uniform Limited Liability Company Act ("RULLCA") as issued in 2006. However, the New Act also differs from RULLCA in several important respects.

B. THE NEW ACT VS. THE CURRENT ACT—GENERAL COMMENTS

In the paragraphs below, I will point out a number of features of the New Act that I believe are unfortunate and should be amended. However, on balance, the New Act will unquestionably make a major contribution to Utah business law, and the Utah business community owes a great debt to its drafters.

1) The New Act takes advantage of the extensive LLC expertise of the lawyers and law professors who drafted RULLCA.

2) As pointed out in an excellent article by Russell Smith entitled "*Utah Should Adopt a Modified Version of the Revised Uniform Limited Liability Company Act*," UTAH ONLAW No. 1 (2013), the New Act addresses and seeks to effectively resolve *all* of the significant problems that inhere in the Current Act. On the basis of RULLCA and their own efforts, the drafters of the New Act have included literally hundreds of what seems to me to be excellent provisions in it. Indeed, in my view, the great majority of its provisions are excellent.

3) Thus, in the years to come, the extensive Comments provided by the RULLCA drafters on the provisions of that act are likely to be of great value to Utah lawyers and courts interpreting the New Act.

C. SHOULD "OLD ACT LLCS" ELECT TO BE GOVERNED BY THE NEW ACT BEFORE JANUARY 1, 2016?

1) Old Act LLC adaptation to the New Act.

   a) Before discussing the New Act in detail, I want to briefly address the issue of what, if anything, Utah LLCs formed under the Old Act ("Old Act LLCs") should do to adapt to the New Act.

   b) This is, of course, a significant question not only for Old Act LLCs but also for Utah LLC lawyers. Advising existing LLCs about how to adapt to the New Act can provide major benefits to these LLCs and also significant fees for Utah LLC lawyers.

2) The many differences between the Old Act and the New Act; adaptation of Old Act LLCs to the New Act.

   a) As noted, the New Act differs from the Old Act in many important respects. As you probably know, the differences between the Old and New Acts are addressed comprehensively in Utah Bar Business Section CLE materials. Thus, I will not attempt to address them comprehensively here.

   b) Moreover, the New Act provides many important many statutory advantages not available under the Old Act. These include, for example:

      i) The validation of oral and implied operating agreements; and

      ii) Substantially stronger charging orders protections.

3) Most Old Act LLCs should elect early coverage. Because of the above and other provisions of the New Act, most Utah Old Act LLC, regardless of their size or complexity, will find it advantageous on a net basis to elect to be covered by the New Act.

4) Some Old Act LLCs should *not* elect early coverage. However, for some LLCs, at least a small number of provisions of the New Act may *disadvantageous.* These LLCs need to be aware of these provisions and, to the extent possible, to override them in their operating agreements. Simple examples are the default voting and fiduciary provisions of the New Act.

5) Elections by larger LLCs. Thus, if they have the financial resources to do so, Old Act LLCs, before they make such an election, should retain an LLC lawyer to advise them as to the impact of the election and to assist them in making the changes in their operating agreements necessary to override disadvantageous provisions. In other words, they should look before they leap. In order to help them prepare properly for their election:

   a) Their lawyers must have a thorough knowledge of the Old Act, the New Act and the differences between them.

   b) These lawyers must also have a thorough knowledge of the deal among the members of LLCs who are seeking this advice, and to the extent that the members haven't fully articulated this deal, these lawyers must help them to do so.

   c) In providing this advice, these lawyers must be very clear with the members as to whom they are representing in providing their advice.

6) Elections by smaller LLCs.

   a) However, because the above legal service requires extensive LLC expertise and will often require many hours of legal work, it may be quite expensive, especially for complex LLCs. Thus, "low-stakes" LLCs—e.g., those with only one or two members and fair market values of, say, less than $100,000—should simply make the election *without* legal advice, since they will be subject to the New Act on January 1, 2016 in any event. In other words, they should leap before they look. There are probably many tens of thousands of such LLCs in Utah.

b) But these LLCs should be aware that if they do so, there may be at least a small possibility that the early election may be disadvantageous to them.

D. WHAT FACTS ARE RELEVANT IN EVALUATING THE NEW ACT?

1) Five factual suppositions. In evaluating the New Act, we must identify the key public policies that it should reflect. To do so meaningfully, however, we must first identify the principal *facts* that are relevant in choosing those policies. I suggest that there are six main reasonable suppositions as to these facts:

   i) Member "numerosity." IRS filing statistics suggest that:

      (1) About 55% of all LLCs are single-member LLCs whose members are individuals;

      (2) About 40% of all LLCs have only two members; and

      (3) Only about 5% of all LLCs have three or more members.

      There are no statistics about the number of members of Utah LLCs, but my discussions with Utah lawyers suggest that the above statistics apply in Utah.

   ii) Utah LLC economics. My discussions with Utah lawyers suggest that most LLCs are *small* businesses-- not only because they have only one or two members but also because their capitalization and their gross and net revenues are relatively small.

   iii) Lack of operating agreements. My discussions with Utah lawyers suggest that:

      (1) Very few Utah single-member LLCs have written operating agreements—perhaps only 10%; and

      (2) Perhaps as few as 40% of Utah multi-member LLCs lack written operating agreements.

   iv) Lack of legal assistance in LLC formations. My discussions with Utah lawyers suggest that most Utah single-member LLCs and a substantial number of Utah multi-member LLCs have been formed without the assistance of lawyers. Given the above "numerosity" factor and economic factors, this is no surprise.

   v) Lack of expert LLC lawyers.

      (1) There are a total of about 8,600 Utah lawyers, including 500 members of the Business Section of the Utah Bar. Perhaps as many as 1,000 of these 8,600 lawyers form LLCs for Utah clients from time to time.

      (2) However, my discussions with Utah lawyers suggests that many lawyers who assist clients in forming Utah LLCs have only a very general knowledge of Utah LLC law and that only a few dozen of them are LLC experts. For example:

         (a) Many of these lawyers don't know the importance of the pick-your-partner and charging order provisions of Utah LLC statutory law.

(b) Many are unaware of the importance of properly classifying the provisions of the New Act relevant to LLCs as definitional, mandatory, default, self-enabling permissive or non-self-enabling permissive provisions.

(c) Many have little or no familiarity with the more important Utah LLC cases.

(d) Some might not even be able to explain the difference between LLC allocations and LLC distributions.

2) Why are there relatively few Utah lawyers with expertise in LLC law?

a) My review of the course offerings of the BYU and UU law schools suggests that these schools offer no courses on LLC law as such, only minor treatment of LLCs in business organization law courses, and no courses or seminars on LLC formation practice.

b) For virtually all Utah lawyers, LLC formations constitute only a relatively small portion of their practices. Thus, for many of them, devoting substantial time to developing substantial LLC expertise may not make sense.

c) Many lawyers view LLC law as predominantly partnership tax law. This deters them from seeking to develop LLC expertise.

E. THE PUBLIC POLICIES THAT SHOULD UNDERLIE THE NEW ACT; THE NEW ACT'S COMPLIANCE WITH THESE POLICIES

Set forth below are (i) my suggestions, based on the above factual suppositions, as to the public policies that ought to underlie the New Act (and, indeed, in my view, *all* LLC acts); (ii) a few comments on whether the New Act properly reflects these policies; and (iii) my comments on how to deal with the principal deficiencies I believe inhere in the Act.

1) Maximum user-friendliness for small businesses.

a) LLCs are inherently complex. However, as noted, most Utah LLCs have only one or two members, limited capital and little or no sophistication about LC matters; and they can't afford lawyers with LLC expertise.

b) By contrast, larger Utah LLCs can afford LLC lawyers to tailor their LLCs to meet their needs.

c) Thus, Utah LLC statutory law should be drafted predominantly to meet the needs of small Utah businesses. It's a matter of simple fairness.

d) In particular, an LLC act should be drafted so as to provide "off-the-shelf" operating agreements for small-business LLCs that lack these agreements. To the extent possible, these off-the-shelf operating agreements should address by statute all issues that well-drafted written operating agreements would address. A well-drafted LLC act should contain off-the-shelf operating agreements:

(1) For single-member LLCs whose members are individuals; and

(2) For multi-member LLCs with general partnership management structures.

ii) Lawyers should be prepared to explain the usefulness of off-the-shelf operating agreements to their clients but also to explain the many functions that written operating agreements can perform for them but which off-the-shelf operating agreements cannot perform.

e) Is the New Act as user-friendly as reasonably possible for Utah small businesses?

i) Features of the New Act that are user-friendly for small businesses. In my view, the New Act is reasonably friendly to small Utah businesses. For example:

(1) Validation of oral and implied operating agreements. The new rule in the New Act validating oral and implied operating agreements is the right rule for Utah small businesses, since so many of them lack written operating agreements.

(a) It is true that the terms of oral and implied operating agreements may sometimes be difficult to provide. However, this disadvantage is outweighed by the many advantages for small businesses of statutorily validating these agreements.

(2) Validation of direct actions. The New Act's authorization of direct actions by LLC members is a significant benefit for small LLCs, since, among other advantageous, it frees these members from the costs and complexities of derivative actions.

(3) Section 602(5)(a). The biggest single business organization law issue for two-member LLCs is how to address member deadlocks and member incompatibility. Section 602(6), which permits members to apply to the courts to remove other members for misconduct without a dissolution of the LLC, seems to me to go far in addressing this issue.

ii) Provisions of New Act that are not user-friendly for small businesses. However, in my view, the New Act is unfriendly to small businesses in a few significant respects:

(1) Allocations

(a) Definitions. As most or all of you will know, LLC allocations are apportionments on their books of the members' respective shares of LLC profits and losses. By contrast, distributions are actual bargained-for transfers of LLC assets to members in their capacity as members (and not as compensation for services).

(b) The absence of an allocation provision in the New Act. The drafters of the New Act apparently believed that allocation provisions in the New Act could sometimes result in adverse federal tax consequences. Thus, like all acts based on RULLCA, the New Act has no allocation provision.

(c) The New Act should have an allocation provision. In my view, the lack of a default allocation provision in the New Act is likely to be harmful to many small businesses, because it will create a substantial lack of clarity about allocations and thus may give rise to a significant number of disputes about how LLC profits should be shared among the members. I think the New Act should contain a default provision that an LLC's profits and losses shall be allocated among the members in accordance with their capital contributions. I am confident that this will rarely, if ever, lead to adverse tax audits.

(i) In the meantime, you should be acutely aware of the absence of allocation provisions in the New Act and you must be sure to remedy this lack in any operating agreement you draft.

(d) Charging order issues. The lack of a statutory allocation provision in the New Act may create serious problems under the New Act's charging order provisions. See Section 503(3), under which, apparently, unsatisfied creditors of LLC members can foreclose on debtor-members' transferable interests but not on their rights to allocations. While the matter is unclear, this situation may result in serious tax problems for these members and economic unfairness to creditors.

(2) Inadequate provisions for single-member LLCs whose members are individuals.

(a) Disadvantageous provisions.

(i) A number of provisions of the New Act—e.g., its bankruptcy dissolution provision—are disadvantageous to single-member LLCs whose members are individuals, and the New Act fails to adequately address a number of issues likely to be important to single-member LLCs.

(ii) Section 701(3). It may also be questioned whether New Act, Section 701(3) will work for single-member LLCs owned by individuals. This provision provides, in effect, that when an individual who is the only member of an LLC dies, the member's heirs must consent to admit a new member within 90 days after the member's death. Many such heirs are likely to be unaware of this rule, and the rule may have result in the dissolution of many single-member LLCs and thus in significant legal damage to them.

(b) Amendments for single-member LLCs. The New Act should be amended to include as many provisions as possible that are likely to be advantageous to these LLCs.

(c) Drafting operating agreements for single-member LLCs. In the meantime, in any operating agreement you draft for single-member LLCs, you should specifically override all provisions of the New Act that are unfavorable to these LLCs and should address all issues that

are important to these LLCs but not addressed in the New Act. See further discussion in Parts 7 and 8.

(3) Wrong standard of care. In my experience, most members of small multi-member LLCs want all of the members to have a duty of care whose standard is "reasonableness," not "avoidance of gross negligence."

(a) Wherever appropriate, in drafting operating agreements, you should replace the above gross negligence standard with a reasonableness standard.

(4) Lack of default rule for statutory agency authority. The lack of a "statutory agency authority" in the New Act is disadvantageous for small businesses. I will address this lack in greater detail below.

(5) No tables of contents; problems with the "part" structure of the New Act.

(a) The New Act should begin with a summary table of contents and a detailed table of contents that will make it easier for non-lawyers and lawyers who are not LLC experts to find specific provisions in the Act, and the captions of the "parts" of the act should be revised for the same purpose.

(b) For example, the New Act should contain parts specifically covering voting rules, fiduciary rules, dissociation rules, and rules governing single-member LLCs.

2) Maximum contractual flexibility.

a) The New Act should provide the members of both small and large Utah LLCs with maximum contractual flexibility to tailor their LLCs in their operating agreements to meet member and LLC needs.

b) The New Act contains several self-enabling and non-self-enabling permissive provisions that provide LLC members with broad flexibility, especially to fiduciary matters.

c) However, it should also contain a "general" or "omnibus" provision like that contained in the LLC acts of Delaware and many other states. Section 18-1101(b) of the Delaware Limited Liability Company Act (the "DLLC Act") provides that "it is the policy of this Act to provide the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."

i) In the meantime, if an LLC formation client of yours needs greater flexibility in an LLC operating agreement than the New Act can provide, you should consider forming the LLC for the client under the DLLC Act.

3) Optimal "social enterprise" provisions. The New Act should provide a solid statutory foundation for Utah social enterprises—i.e., enterprises that are for-profit business but that have one or more significant humanitarian goals. Utah is well known for its humanitarian commitments and also for its commitment to business excellence. Social enterprise provisions can simultaneously support both of these commitments. See further discussion immediately below concerning the L3C provisions of the New Act.

F. THE STATUTORY AGENCY PROVISIONS OF THE NEW ACT

1) The importance of LLC statutory agency provisions. One of the most important functions of any LLC statute is to make clear who may validly exercise LLC agency authority—i.e., who may bind the LLC in oral and written contracts and in statements about the LLCs—and who may not. Clearly, this is a critical issue:

   a) For LLCs; but also

   b) For persons who act or want to act or are asked to act as LLC agents; and

   c) For third parties that deal with LLCs.

2) The approach of many non-Utah LLC acts. Many LLC statutes provide in *mandatory* rules that:

   a) The articles of organization or similar document of LLCs must specify whether the LLCs covered by them are member-managed or manager-managed.

   b) All of the members of member-managed LLCs automatically have agency authority for their LLCs as a matter of law; and

   c) All of the managers of manager-managed LLCs automatically have this authority as a matter of law.

   See, e.g., Revised New Hampshire Limited Liability Company Act, Sections 15, II(d) and 52.

3) The approach of the New Act. The New Act takes a very different approach.

   a) Section 301 of the New Act provides in effect that the mere status of a person as a member of a member-managed LLC does not endow that person with agency authority.

   b) I have found no provision of the New Act that provides that the mere status of a person as a manager of a manager-managed LLC does not endow that person with agency authority. However, in his article on the New Act, Russell Smith indicates that this is the case by the very silence of the Act.

   c) Agency authority under the common law. The common law of agency as restated in the Restatement of Agency, Third recognized two types of agency authority:

      i) Actual authority. Persons generally have "actual" agency authority for an LLC if these persons reasonably believe themselves to be agents on the basis of "manifestations" to them by the LLC. If persons have actual agency authority, their acts bind both these LLCs and third parties dealing with their principals, and the persons themselves have the rights, duties and liabilities of agents.

      ii) "Apparent authority." Persons generally have "apparent" agency authority for LLCs in dealing with third parties and can bind both the LLCs and the third parties if the third parties reasonably believe they are agents of these LLC on the basis of the LLCs' "manifestations" to the third parties.

d) Actual and apparent authority under the New Act. Presumably:

i) If a written, oral or implied operating agreement of an LLC under the New Act provides that any particular person is an agent of the LLC, that person will have actual authority as an agent of the LLC.

ii) If the operating agreement does not so provide, the person will have apparent authority if it "manifests" to the third party that the person is its agent.

e) Statements of authority under Section 302. However, Section 302 provides that an LLC may file a "statement of authority" specifying which persons have agency authority for it and that if the LLC does so, third parties will be deemed to have knowledge as to the agency authority of these persons and that no other persons will be deemed to have that authority.

f) "Authorized persons." Section 203(1)(a) provides that in order to bind an LLC, a statement of authority delivered by it to the Division of Corporations for filing will bind the LLC when filed if the statement is signed by "a person authorized by the limited liability company." But if a statement of authority is filed in the name of a particular LLC, the LLC will presumably be deemed to be aware of the statement and of the identity of the signer. Thus this signer will have actual authority to act as an agent of the LLC in delivering the statement for filing.

4) Should the agency authority of the New Act be amended? In my view, the above provisions of the New Act are unfriendly to Utah small businesses:

a) Utah LLC statistics. As noted, around 55% of Utah LLCs are probably single-member LLCs whose members are individuals. The above non-Utah approach to the LLC agency authority will work well for most of them, for the roughly 40% of Utah LLCs that have only two members, and for most Utah LLCs with three or more members.

b) Many Utah LLCs don't have written operating agreements. As noted above, it is likely that a substantial majority of small business LLCs formed under the New Act do not have written operating agreements.

c) Most members of Utah will never become aware of Section 302. The members and managers of most small-business LLCs are unlikely to be aware of Section 302, much less to take advantage of it by filing a statement of authority with the Division of Corporations.

d) Section 301 is unfriendly to Utah small businesses. Thus, if there is ever an issue for a Utah small-business LLC, for its members and managers, for persons acting as its agents, and for third parties as to who is a valid agent of these LLCs, it may be difficult and expensive to resolve this issue.

5) Amending the New Act agency provisions.

a) Thus, I think that the New Act should be amended so that it addresses the issue of LLC statutory agency authority in the manner in which this issue is addressed in most other LLC acts.

b) However, I think that these amendments should provide that members of member-managed LLCs and managers of manager-managed LLCs will be LLC agents *unless a statement of authority provides otherwise*. Thus, the above provisions will effectively be default provisions that can be overridden by the filing of statements of authority.

c) This filing mechanism will eliminate a potentially difficult and expensive examination of any individual LLC's operating agreement. Such an examination may be particularly difficult by reason of the fact that the New Act validates not only written but also oral and implied operating agreements.

6) Dealing with Section 301. Unless and until the New Act is amended to address the above issues under Section 301, you should generally address these issues by filing statements of authority for LLCs you form and by advising your clients to amend these statements whenever necessary. These filings will not only make crystal-clear the identity of the persons authorized to bind the LLC and the scope of their authority but will also help to prevent third parties from obtaining any right to inspect the LLC's operating agreement.

G. SECTION 112(3) OF THE NEW ACT

1) Introduction. I want to turn now to a discussion of Section 112(3) of the New Act. It is perhaps the most important single provision in the New Act from an LLC formation viewpoint. First, however, some background:

2) Section 112(3)--overview.

a) Section 112(3) is itself a mandatory provision of the New Act. Its purpose is to identify which of the hundreds of other provisions of the New Act are mandatory provisions and which are not.

b) The section does so by identifying 14 specific provisions and categories of provisions of the New Act that the operating agreement may not alter. By virtue of Section 112(3), all provisions of the Act *not* identified in the Section as mandatory are either definitional, default, self-enabling permissive or non-self-enabling provisions.

3) Exhibit 4-1—list of the 14 mandatory provisions and categories of provisions in the New Act. In Exhibit 4-1 of this outline, I've briefly summarized each of the above 14 provisions and categories of provisions identified in Section 112(3). Let's take a quick look at that exhibit.

4) Critique of Section 112(3).

a) The approach to the identification of mandatory provisions in LLC statutes is the one taken in RULLCA; I assume that is why the New Act takes this approach.

b) However, I believe that the approach that Section 112(3) takes in identifying the mandatory provisions of the New Act is highly *non*-user-friendly:

i) To non-lawyers, such as most LLC members and managers, who want to understand the New Act; and

ii) Even to lawyers and judges handling matters under the New Act who are not LLC specialists.

c) This is because many non-lawyers and non-LLC specialist lawyers and judges may be unaware of Section 112(3) when they read the New Act, or they may not fully understand the function of the section. As a result, when these people read the New Act, they may interpret as mandatory many provisions that the Utah legislature intends to be mere default provisions.

5) The right way to identify mandatory and other provisions. In my view, by far the simplest and most user-friendly method of identifying the above five types of provisions in the New Act is by specific terms *within these provisions*. Specifically:

a) Each definitional provision should always contain the word "means."

b) Mandatory provisions should always be identified by the use of the terms "must" or "shall."

c) Each default provision should begin with the phrase "unless the operating agreement provides otherwise."

d) Each self-enabling permissive provision should contain the phrase "the limited liability company by vote of its members or managers."

e) Each non-self-enabling permissive provision should contain the phrase "the operating agreement may provide that. . ."

6) The approach of other states. I'm not alone in the above views. To my knowledge, the only states that use the Section 112(3) approach are those that have used RULLCA as the basis for their LLC acts. To my knowledge, all other states, including the Delaware LLC Act, use the approach I recommend above.

7) Delete Section 112(3)! Thus, I believe that Section 112(3) should be deleted from the New Act and that the above phrases should be included in each provision of the New Act that doesn't presently contain them.

8) Section 112(3)(k)—direct and derivative suits. Finally, even if Section 112(3) is not deleted from the New Act, I believe that Section 112(3)(k) should be amended to make clear that an operating agreement may provide that members will not be required to bring direct or derivative actions against the LLC, managers and other members in court as long as they have the right to bring these actions in arbitration in a specified state.

9) Dealing with Section 112(3). Unless and until the Utah Legislature addresses the above Section 112(3) issues, you should address them yourself:

a) With the help of the attached Exhibit 4-1; and

b) With the help of the master checklist and the five sub-lists of New Act provisions relevant to LLC formations discussed in Part 2 of this Outline.

H. THE L3C PROVISIONS OF THE NEW ACT

1) Introduction.

   a) The New Act, like the Current Act, contains provisions for a special subset of LLCs defined in New Act Part 1, Section 102(11) as "low-profit limited liability companies." The L3C provisions of the New Act other than this definitional provision are contained in Part 13 of the New Act, Sections 1301 through 1304.

   b) In essence, L3Cs are designed for use by *for*-profit LLCs whose certificates of organization provide that they are "low-profit limited liability companies" ("L3C LLCs") under the governing LLC act. The hope of the drafters of the drafters of the Current and New Acts is that an LLC's status as an L3C will attract investment from foundations and support from members of the public who favor social benefit enterprises.

   c) How many attendees are familiar with L3Cs and with the L3C provisions in the New Act?

2) L3C states. Utah is one of nine states whose LLC acts contain L3C provisions—namely, Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont, and Wyoming. The laws of the federal jurisdictions of the Crow Indian Nation of Montana and the Oglala Sioux Tribe also provide for L3Cs.

3) What is the purpose of L3Cs?

   a) As indicated, supporters of L3Cs hope that the "L3C brand" will attract private foundations and other tax-exempt organizations to invest in L3Cs along with traditional for-profit investors. These for-profit investors may include both:

      i) "Socially responsible investors" ("SRIs")—investors who want to invest in business entities that provide significant social benefits; and

      ii) Conventional investors such as angels, venture capital funds and private banks.

   b) "Social benefits" in this context mean, in general, the charitable and educational benefits for which federal income tax exemptions are available under Internal Revenue Code § 501(c)(3).

   c) L3C supporters hope that combining exempt organization ("EO") and non-EO investment in a private for-profit entity will provide major social benefits.

4) Private foundations.

   a) Definition. Private foundations are, in essence, entities that have met IRS tests for charitable exemptions from federal income taxation under Internal Revenue Code Section 501(c)(3) but that are primarily funded not by contributions from the general public but by one or more wealthy individuals or families.

   b) The number of private foundations; their assets. There are presently about 84,000 private foundations in the U.S.—including, no doubt, many thousands in Utah. U.S. private foundations collectively have assets of over $600 billion. The largest private foundation is the William and Melinda Gates Foundation, which has assets

of roughly $38 billion.

c) Private foundation asset distribution requirements; "PRIs." Private foundations are required to distribute 5% of their assets every year. However, Treas. Reg. § 53.4944-3 provides that "program-related investments" ("PRIs") of private foundations count toward this 5% . In essence, PRIs are investments that private foundations make in for-profit entities for charitable or educational purposes—i.e., purposes consistent with their non-profit "programs"—and not for the purpose of earning profits or of realizing realize gains from asset appreciation. Treas. Reg. § 53.4944-3 provides that if these investments meet the tests set forth in that regulation, private foundation PRIs will not trigger adverse federal tax consequences for these foundations.

d) Private foundations and L3Cs. It is often difficult for private foundations to find appropriate recipients for their asset distributions. L3C law has been developed specifically to enable LLCs to be apt PRI recipients.

e) PRI risks. However, it may sometimes be difficult to be certain that a particular private foundation's PRI meets IRS tests, and the federal tax consequences of a failure to meet them may be severe both for the private foundations themselves and for their managers.

5) The L3C provisions of the New Act—overview; L3Cs as a "brand." The L3C provisions in the New Act are based on widely adopted model provisions. They may be summarized as follows:

i) Section 1302(1)—basic requirements for L3C status. Section 1302(1) requires that in order to be an L3C, an LLC must:

(1) Be organized under the New Act;

(2) Contain in its name the abbreviation "L3C" or "l3c";

(3) State in its certificate of organization that it is a low-profit limited liability company; and

(4) Be organized for a business purpose that satisfies the requirements of Section 1302(2).

As noted, the hope of the social enterprise community is that because of provisions like those summarized above, L3Cs will eventually become a leading "brand" for social entrepreneurs and that SRIs, conventional investors and the general public will come to trust them as attractive vehicles for thousands or tens of thousands of social enterprises.

ii) Section 1302(2). Section 1302(2) is essentially a photocopy of Treas. Reg. § 53-4944-3. The section provides, in essence, that:

(1) An L3C must have a charitable or education purpose within the meaning of IRC Section 170(c)(2)(B) – i.e., religious, charitable, scientific, literary, or educational purposes, or [the purpose of fostering] foster national or international amateur sports competition. . . or for the prevention of cruelty to children or animals"; and

(2) An L3C may not have as a significant purpose the production of income or the appreciation of property.

iii) Section 1302(3). However, Section 1302(3) effectively provides that the fact that an L3C earns profits and has appreciated property is not conclusive evidence that it has "as a significant purpose the production of income or the appreciation of property."

6) Critique of Utah L3C provisions.

a) The promise of L3Cs. Both L3C statutory law and federal tax law concerning PRIs are just beginning to develop. L3Cs offer a promising new way for charitable and for-profit entities to work together for the public good. They also offer a new direction in Utah LLC practice that may be rewarding to Utah lawyer both professionally and personally. However, the L3C provisions in the LLC acts of the jurisdictions that have enacted these provisions—and which appear to be the model for the Utah L3C provisions—have been sharply criticized by leading LLC lawyers and scholars and, indeed, by the ABA.

b) The need for Congressional or IRS blessing. My sense is that many EOs and their advisers are unlikely to invest in L3Cs until either Congress or the IRS somehow specifically blesses them.

c) The need to revise the New Act's L3C provisions. In addition, in my view, the L3C provisions of the New Act need substantial revision in order to achieve their goals.

i) The name "L3C." The very name "low-profit" LLC is a misnomer, since the purpose of L3C provisions is to attract private foundation investments in for-profit LLCs as long as these LLCs have a significant charitable purpose. Thus, a better name for these LLCs might be "social benefit LLCs."

ii) Defining L3Cs. L3C provisions should not define L3Cs as non-profit companies. They should define them as LLCs that have at least one significant charitable purpose and at least one member that that is a private foundation or a public charity.

iii) EO vetoes and redemption rights. L3C provisions in LLC statutes and in the operating of L3Cs should perhaps provide, among other things, that:

(1) The EO member will be entitled to no profit on its investment.

(2) The EO member may veto any action by the L3C that is contrary to its charitable purpose.

(3) The EO member may resign from the LLC and receive back the cash value of its investment (but nothing more) on redemption terms that do not unduly burden the LLC.

d) B corporations vs. L3Cs. There is current much scholarly and legislative working relating to the structuring of state law business corporations as "benefit corporations." B corporations have much the same purpose as L3Cs. However,

the main model B corporation statute seems to me to be seriously flawed, and the fact that, under the Check-the-Box Regulations, state-law corporations cannot qualify for partnership tax gives L3Cs a major federal income tax advantage over B corporations in asset sales of benefit entities.

7) Dealing with the L3C provisions of the New Act. In the meantime, if you are working with clients to form a social benefit LLC, you should not rely on the L3C provisions of the New Act and, arguably, should not "brand" your LLC as a Utah L3C. Rather, you should do all you can to ensure that the provisions of the operating agreement of the social benefit LLC that you are forming address all relevant EO issues.

I. THE SERIES PROVISIONS OF THE NEW ACT

1) Series LLCs in the New Act. Part 12 of the New Act, comprising New Act sections 1201 through 1209, authorizes LLCs formed under the New Act to provide in their certificates of organization that they are series LLCs and thus that they may validly form LLC series.

2) What are LLC series?

   a) LLC series are something like wholly owned single-member LLC subsidiaries of series LLCs, except that a series LLC may form series without any series-by-series filing with the Division of Corporations.

   b) Each series has its own liability shield; this shield protects members "associated" with the series from claims against the series, and it shields the series itself from claims against other series of the LLC and from claims against the LLC itself.

   c) Series LLCs may associate with any of their series not only series LLC members but also series LLC assets, lines of business, and liabilities.

3) LLC series are legal and tax disasters waiting to happen. The concept of series LLCs is a highly creative and even daring idea. However, there are many serious and unanswered legal and tax questions about series LLCs. The most important of these questions are:

   a) Whether the liability shields of LLC series will be respected in states whose LLC acts do not contain series provisions; and

   b) Whether bankruptcy courts will respect these shields.

4) How should you deal with the series LLC provisions of the New Act?

   a) In my view, the inclusion of series provisions in an LLC act is inadvisable, since the seeming state sanction of these provisions may lead unsuspecting business people in the state to form them and then fall prey to the above questions.

   b) In general, I suggest that because of the above risks, you should not form series LLCs for your clients.

c) In any event, I believe that if you do form series LLCs for your clients, you should first provide your clients with comprehensive written warnings about these risks and should ask your clients to acknowledge in writing that they are aware of them.

d) A more comprehensive discussion of the risks involved in using series LLCs and the amendments in the New Act that address them may be found in Russell Smith's article on the New Act, *supra* at pages 41 through 45 and the accompanying footnotes.[1]

[1] An excellent summary of the L3C provisions currently employed in LLC acts and ways in which these provisions can be amended to address criticisms of them may be found in Brewer, "Seven Ways to Strengthen and Improve the L3C," http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2192691. Professor Brewer is a national leader in the field of L3C law and taxation.