

PART 9. PLANNING, NEGOTIATING AND DRAFTING OPERATING AGREEMENTS FOR MULTI-MEMBER LLCs

OVERVIEW

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EXHIBITS

- EXHIBIT 9-1 Summary and detailed tables of contents of Form 3.1
 - EXHIBIT 9-2 “Issues memo” for LLC formation clients
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A. THE TABLES OF CONTENTS OF FORM 3.1 AS AN ISSUES CHECKLIST IN FORMING MULTI-MEMBER LLCs; PRE-FORMATION ISSUES MEMOS FOR CLIENTS

- 1) The summary and detailed tables of contents of Form 3.1. The summary and detailed tables of contents of Form 3.1 will provide you with a quick overview of the many dozens of tax and non-tax issues normally relevant in forming multi-member LLCs. I will not attempt to address these issues comprehensively here. Rather, I will focus only on key fiduciary issues, issues concerning events of dissociation, and buy-sell issues. A copy of this table of contents is attached as Exhibit 9-1.
- 2) “Issues memos.” I have found it very useful, before meeting with clients to discuss proposed formations of multi-member LLCs to provide them with “issues memo” to review, discuss among themselves, and, if they’re willing to mark up and send back to me.

B. HANDLING LLC BUSINESS ORGANIZATION LAW FIDUCIARY ISSUES IN OPERATING AGREEMENTS

- 1) What are “fiduciary duties”?
 - a) Fiduciary duties are the equitable duties that, unless the parties agree otherwise, apply automatically to persons who agree to handle the business or personal affairs of other persons.
 - b) Fiduciary duties provide the ethical structure of LLCs and their “team spirit.”
- 2) The concept of “fiduciary issues.” Fiduciary issues include issues relating to the two core fiduciary duties—the duties of care and loyalty—and several related issues, including issues concerning the right of LLC members to investigate, challenge and remedy member and manager misconduct. These related issues include those concerning:

- a) Member information rights;
 - b) Dispute resolution rights;
 - c) Increase, reduction and elimination of fiduciary duties; and
 - d) Exculpation, indemnification, and advancement of litigation fees.
- 3) The practical importance of addressing fiduciary issues comprehensively in operating agreements. If an operating agreement contains comprehensive, reasonable fiduciary duties:
- a) This can significantly increase the harmony and cooperation among the members and managers; and
 - b) It can prevent member and manager misconduct relating to the LLC.
- I have had occasion to review for clients many operating agreements that entirely fail to address these duties.
- 4) Situations in which operating agreements should eliminate fiduciary duties
- a) Founder wants to protect his or her manager from other members.
 - b) Founder is also manager and wants to protect himself or herself from other members.
- 5) The duty of care
- a) The duty of care prohibits negligent LLC management.
 - b) Should such a duty apply at all?
 - c) What standard of care should apply? The standard in the New Act seems to me to be a very pro-management standards—namely that of refraining from gross negligence, reckless conduct, intentional misconduct and knowing violations of law. Section 409(3).
- 6) The duty of loyalty
- a) Definition. The duty of loyalty is a duty to act in the best interest of the LLC and not in one's own interest.
 - b) The eight subsidiary duties of loyalty
 - i) Duty not to compete;
 - ii) Duty not to usurp business opportunities;
 - iii) Duty to refrain from self-interested transactions;
 - iv) Duty to avoid improper personal benefits;
 - v) Duty to use LLC property only for the LLC;
 - vi) Duty of confidentiality;
 - vii) Duty of disclosure
 - viii) Duty of good faith.

- 7) Section 409(2). A general duty of loyalty and many of the above subsidiary duties are imposed by New Act, Section 409(2).
- 8) The quasi-fiduciary duty to comply with the implied covenant of good faith and fair dealing.
 - a) Definition. The implied contractual covenant of good faith and fair dealing (the “Implied Covenant”) is an implied duty of contract parties to meet the reasonable expectations of the other contract parties on contract issues:
 - i) Within the scope of the contract;
 - ii) Not addressed in the contract.
 - b) Intent of Implied Covenant. The Implied Covenant is intended to support the enforceability of contracts. It is thus arguably a constitutional requirement.
 - c) The implied contractual covenant of good faith and fair dealing is imposed by New Act, Section 409(4).
 - d) Courts’ reluctance to decide Implied Covenant claims. Particularly in Delaware, the courts are reluctant to decide Implied Covenant cases because they don’t want to second-guess the parties. I assume this is also the case in Utah.
- 9) Increasing, reducing and eliminating fiduciary duties. The New Act provides parties to operating agreements with very broad latitude in increasing and reducing fiduciary duties, but it does not permit them to eliminate these duties altogether. New Act, Section 112(4). DLLC Act § 18-1101(b) permits complete elimination. In some situations complete elimination may be reasonable, but to achieve it, you will have to form your client’s LLC under the DLLC Act.

C. HANDLING MULTI-MEMBER LLC DISSOCIATION ISSUES, INCLUDING BUY-OUTS UPON DISSOCIATIONS

- 1) Dissociation events are events, such as death, that cause LLC members to cease being members. There are five main types of dissociation events—namely, death, disability, resignation, transfers of distributional interests, and expulsion. Defining these events clearly in operating agreements is important not only to ensure valid membership terminations but also to provide appropriate triggering events for redemptions and cross-purchases.
- 2) Dissociation buy-out table. I have found the following table to be indispensable in helping my LLC formation clients to understand LLC events of dissociation and to formulate these duties in their operating agreements in a way that makes practical sense to them.

EVENT TRIGGERING DISSOCIATION	DISSOCIATED MEMBER HAS PUT RIGHT (YES/ NO)	OTHER MEMBERS AND LLC HAVE CALL RIGHT (YES/ NO)
1. Death		
2. Disability		
3. Resignation		
4. Transfer of entire LLC interest		
5. Expulsion		
6. Divorce?		
7. Others? (These may include, for example, a member's failure to adequately provide promised services.)		

3) Issues in structuring the buy-sell provisions of buy-sell agreements

a) Triggering events. See above table.

b) Method of determining buy-out prices. There are four main methods:

- (1) Annual written agreement by the parties;
- (2) Agreement of the parties at the time of the triggering dissociation event;
- (3) Formula; and
- (4) Appraisal by an independent appraiser.

ii) Which method is best for your client?

- (1) This question is much debated. The answer depends on the facts.
- (2) Some lawyers believe that no one is better at evaluating businesses than the people who run them, but LLC members frequently forget to update annual written appraisal agreements.
- (3) Appraisers generally say that formulas and self-appraisals never work and that you need experienced professional appraisers. But I've seen several appraisals in buy-sell situations that were simply off the wall. Perhaps the key is to ensure that your client has total access to the appraiser and to require the appraiser to initially submit his or her appraisal to the affected parties as a draft for comment.

c) Non-price terms. The key non-price terms that may often be appropriate to address in operating agreements of multi-member LLCs are these:

- i) Installment terms;
- ii) Interest terms;
- iii) Terms for collateral securing payment of installments;

- iv) Method of financing buy-outs (including, e.g., life insurance); and
- v) Terms governing closing date and procedures.

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