Model Organizational Checklist for a Limited Liability Company

Limited Liability Company Subcommittee of the LLCs, Partnerships and Unincorporated Entities Committee, ABA Business Law Section

Introduction

Every limited liability company is a unique entity intended to reflect the objectives and agreement of the members (and perhaps other stakeholders) in the business. With few exceptions, there is freedom of contract among those parties to reflect their agreement in the operating agreement. Counsel's obligations are at minimum two-fold: to explain the consequences and implications of the deal points on which decisions have at least provisionally been made and to identify additional matters upon which decisions need to be made. Counsel is then obligated to reflect the agreement in the written instrument.

This checklist is an effort, in an admittedly generic document, to identify certain matters upon which agreement needs to be had and which in most, although admittedly not all, operating agreements that agreement should be set forth.

This document is not business- or transaction-specific. Obviously, the operating agreement of a small accounting firm LLC in which allocations/distributions are based on a formula that looks to client origination, maintenance, and work credits is a substantially different document from that of a syndicated real estate venture in which several pension funds are providing funds and a developer is serving as manager and is receiving an incentive interest. The particulars of the deal in question must be addressed in the operating agreement drafted for that deal. Neither is this document state-specific. As such, we do not devote significant attention to the non-economic member that is possible in Delaware and Kentucky, the board management structure that is available in Tennessee, Minnesota, and North Dakota, and the series LLC available in Delaware, Iowa, Illinois, Texas, and other states. Each state's LLC act has its differences when compared to those of other states, and counsel needs to take account of them in determining choice of jurisdiction in which to organize and in drafting the operating agreement.

It is not possible to draft an operating agreement without taking into account the tax implications of the arrangement being memorialized in the operating agreement. That said, this checklist is not intended to provide a comprehensive education regarding the implications of various elections and determinations vis-à-vis either an individual member and the LLC or among the members. In

many instances we have provided indications of the tax consequences of particular elections, but that no tax effect of a particular provision is identified should not be interpreted as an indication that there is no tax effect. The footnotes are intended to identify many substantive issues and to inspire the readers to investigate potential issues more closely on their own.

The Committee on LLCs, Partnerships and Unincorporated Entities has published *Model Real Estate Development Operating Agreement*, 63 BUS. LAW. 385 (2008). That agreement is an exploration of how an operating agreement could be written for a particular fact situation, namely a three-party real estate development, and under the laws of a particular state, namely Delaware. In addition, this Committee has published *Model Limited Liability Company Membership Interest Redemption Agreement*, 61 BUS. LAW. 1197 (2006), and the Mergers and Acquisitions Committee of the Business Law Section of the American Bar Association has published MODEL JOINT VENTURE AGREEMENT (2006). This checklist is not intended to be a companion to any of those agreements. Rather, this checklist is intended to be broader in scope, not limited to either a particular factual situation for the transaction in question or restricted to any individual state.

This Model Limited Liability Company Organizational Checklist is a project of the Limited Liability Company Subcommittee of the LLCs, Partnerships and Unincorporated Entities Committee, Business Law Section, American Bar Association.

This model is the product of contributions from many individuals over several years, and the following should be recognized for their efforts: Paul M. Altman, Michael A. Bamberger, Louis T. Conti, Allan G. Donn, Curtis L. Golkow, Louis G. Hering, Peter D. Hutcheon, Leon Andrew "Andy" Immerman, W. Alan Kailer, Lewis R. Kaster, Cristin Conley Keane, Robert R. Keatinge, Professor Daniel S. Kleinberger, Scott E. Ludwig, Professor Elizabeth S. Miller, Jennifer Howard Moore, Thomas E. Rutledge, Sherwin P. Simmons, Edward L. Wender, and James J. Wheaton.

Laura D'Angelo and Phuc H. Lu
Co-Chairs

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MEMORANDUM

TO: **File**
FROM:
RE: **LLC Formation Checklist**[1]
DATE: **July 21, 2009**

PART I. Our Client

A. Client is[2]:

1. ☐ Member
2. ☐ LLC
3. ☐ Manager
4. ☐ Member and LLC
5. ☐ More than one Member[3]

1. This checklist necessarily assumes that an appropriate choice of entity analysis has been undertaken and that the conclusion was that an LLC is the most appropriate form for the particular venture. For an extensive analysis of choice of entity issues, see ANN CONAWAY, BRUCE ELY & ROBERT R. KEATINGE, KEATINGE AND CONAWAY ON CHOICE OF BUSINESS ENTITY (2014) [hereinafter KEATINGE & CONAWAY]; *see also* CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶¶ 3.01–.12 (2014) [hereinafter BISHOP & KLEINBERGER]; 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES §§ 2:01–2:38 (2014) [hereinafter RIBSTEIN & KEATINGE].

2. Identify who is the client and make that determination clear not only to the client but to others who may believe or assert an attorney-client relationship. The situation is complicated by the fact that if the client is the LLC, then the client does not exist before filing the articles of organization/certificate of formation. Some states apply the incorporation rule under which the organizers consult with an attorney regarding the formation of a business entity, and upon its formation, the attorney-client relationship shifts to the newly formed business structure. *See*, *e.g.*, Manion v. Nagim, C.A. No. 00-238 ADM/RLE, 2004 U.S. Dist. LEXIS 1776, at *10–11 (D. Minn. 2004), *aff'd*, 394 F.3d 1062 (8th Cir. 2005); *but see* Pucci v. Santi, 711 F. Supp. 916, 927 n.4 (N.D. Ill. 1989) (attorney for partnership also represents each general partner); Schwartz v. Broad. Music, Inc., 16 F.R.D. 31, 32 (S.D.N.Y. 1954) (each member of unincorporated association is client of association's attorney); N.Y.C. Bar Ass'n Comm. on Prof'l & Judicial Ethics, Formal Op. 1986-2 (1986); Thomas E. Rutledge & Phuc H. Lu, *No Good Deed Goes Unpunished: Pitfalls for Counsel to a Business Organization About to Be Governed by a New Law*, 45 BRANDEIS L.J. 755, 770–71 (2007). In *Montgomery v. eTreppid Technologies, LLC*, 548 F. Supp. 2d 1175, 1183–88 (D. Nev. 2008), the court held that counsel to an LLC were counsel to it as a distinct legal organization, that a former manager and member was not a joint client with the LLC for that time he was its manager for purposes of privilege, and that communications between the LLC and its counsel were not discoverable in a dispute between that former manager/member and the LLC.

3. Counsel should consider whether there are potential problems with counsel representing all of the LLC members during the formation or operational stages of the LLC. For example, the competing interests of the members may be so strong or antagonistic to create unavoidable conflicts of interests. Indeed, there is potential for this complication to arise whenever there is multiple representation in business organizations. It may be advisable for the LLC members to have separate representation. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7 cmts. 8, 18, 29–32 (2013).

B. Name and address of client[s]:

1. _____

_____

_____

2. _____

_____

_____

C. Engagement letter and waivers[4]: _____

D. Client/Matter number: _____

PART II. Information for Articles of Organization[5]

A. Jurisdiction of organization[6]: _____

4. Letters to other initial members who will be involved in the organization but who are not represented should be considered as well. *See* GARY A. MUNNEKE & ANTHONY B. DAVIS, THE ESSENTIAL FORMBOOK: COMPREHENSIVE MANAGEMENT TOOLS FOR LAWYERS 273–80 (2000). Consider whether the operating agreement should recite for whom the drafting attorney was engaged, who is that attorney's client, and who is not the attorney's client.

5. In certain states the initial filing with the Secretary of State is designated "Articles of Organization" or a "Certificate of Formation." *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-201 (LEXIS through 2014 Fiscal Sess.) (certificate of formation); KY. REV. STAT. ANN. § 275.025 (LEXIS through 2013 1st Extra Sess.) (articles of organization); N.J. REV. STAT. § 42:2B-11 (LEXIS through 2014 Reg. Sess.) (certificate of formation); N.Y. LTD. LIAB. CO. LAW § 203 (Consol. 2014) (articles of organization); TEX. BUS. ORGS. CODE ANN. § 3.001 (LEXIS through 2013 3d Called Sess.) (certificate of formation); VA. CODE ANN. § 13.1-1010 (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.) (articles of organization); WASH. REV. CODE ANN. § 25.15.070 (LEXIS through 2013 3d Special Sess.) (certificate of formation); *see also* REVISED PROTOTYPE LIMITED LIABILITY COMPANY ACT § 201, 67 BUS. LAW. 117, 142 (2011) [hereinafter RPLLCA] (certificate of formation); REVISED UNIF. LTD. LIAB. CO. ACT § 201, 6B U.L.A. 456 (2008) [hereinafter RULLCA] (certificate of organization).

6. Choice of the jurisdiction of organization will have an impact upon the rules governing the LLC and its owners. For example, although certain states provide a default rule of unanimous approval for amendment of the operating agreement (*see*, *e.g.*, ALA. CODE § 10A-5-4.03 (LEXIS through 2014 Reg. Sess.); MONT. CODE ANN. § 35-8-307(3)(a) (LEXIS through 2013 Reg. and Special Sess.); TEX. BUS. ORGS. CODE ANN. § 101.053 (LEXIS through 2013 3d Called Sess.); VA. CODE ANN. § 13.1-1023(B)(2) (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.)), other states permit the amendment of the operating agreement by less than unanimous approval. *See*, *e.g.*, CO. GEN. STAT. § 34-142(b) (LEXIS through P.A. 14-211 (except 14-175, 14-187 and 14-205)) (2/3ds of the members); KY. REV. STAT. ANN. § 275.175(2)(a) (LEXIS through 2013 1st Extra Sess.) (a majority in interest of the members); OKLA. STAT. tit. 18, § 2020(B)(3) (LEXIS current through Chapter 23 (End) of the First Extraordinary Sess. of the 54th Leg. (2013)) (a majority of the members). For another example, the Delaware LLC act provides that unless the operating agreement provides otherwise, a resigning member is entitled to receive the fair value of its limited liability company interest. DEL. CODE ANN. tit. 6, § 18-604 (LEXIS through 2014 Fiscal Sess.). Other acts provide that a member, upon withdrawing, becomes simply an assignee of its membership interest in the company and has no right to liquidate that interest. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.280(4) (LEXIS through 2013 1st Extra Sess.); RPLLCA § 603(a), *supra* note 5, at 171; RULLCA § 603(a)(3), 6B U.L.A. 504 (2008). *See also* Thomas E. Rutledge, *You Just Resigned—Now What? Different Paradigms for Withdrawing from a*

B. Name of LLC[7]: _____

C. LLC will be[8]:

Venture, J. PASSTHROUGH ENTITIES, Nov./Dec. 2009, at 43; Thomas E. Rutledge, Chapman v. Regional Radiology Associates, PLLC: *A Case Study in the Consequences of Resignation*, 100 KY. L.J. ONLINE 15 (2011). While those and other default rules may be in the operating agreement, not appreciating the underlying default rule can materially affect the agreement. For an overview of the basic approach of LLC statutes including a discussion of selection criteria, see BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 5.01–.04.

7. Each state has a requirement regarding mandatory designators for a limited liability company such as "limited liability company" or "L.L.C." *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-102 (LEXIS through 2014 Fiscal Sess.); FLA. STAT. ANN. § 608.406 (LEXIS through 2013 Reg. Sess.); KY. REV. STAT. ANN. § 14A.3-010(3) (LEXIS through 2013 1st Extra Sess.); N.Y. LTD. LIAB. CO. LAW § 204 (Consol. 2014); TEX. BUS. ORGS. CODE ANN. § 5.056 (LEXIS through 2013 3d Called Sess.); VA. CODE ANN. § 13.1-1012 (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.); *see also* RIBSTEIN & KEATINGE, *supra* note 1, § 4:11. See *infra* note 14 for particular issues involving the name of a professional LLC. Consider also the requirements for "distinguishability" imposed by the laws of the jurisdiction of organization and of states in which it is anticipated the LLC will need to qualify to transact business. State and federal trademark and service mark protections and infringements should also be considered.

8. Some, but not all, LLC acts require a designation in the articles of organization of the LLC as "member-managed" or "manager-managed." *See*, *e.g.*, KY. REV. STAT. ANN. § 275.025(1)(d) (LEXIS through 2013 1st Extra Sess.); MONT. CODE ANN. § 35-8-202(1)(2) (LEXIS through 2013 Reg. and Special Sess.); TEX. BUS. ORGS. CODE ANN. § 101.251 (LEXIS through 2013 3d Called Sess.). States without this requirement include Delaware (DEL. CODE ANN. tit. 6, § 18-402 (LEXIS through 2014 Fiscal Sess.)) (Delaware defaults to member-managed if no designation is made in the operating agreement); Georgia (GA. CODE ANN. § 14-11-301 (LEXIS through 2014 Reg. Sess.)) (Georgia defaults to member-managed if no designation); and Virginia, although Virginia does expressly allow this designation. VA. CODE ANN. § 13.1-1021.1(B)(1) (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.). Similarly, no such election is required under the Revised Prototype LLC Act (*see* RPLLCA § 201, *supra* note 5, at 142) or under RULLCA. *See* RULLCA § 201 cmt. to subsec. b, 6B U.L.A. 458 (2008). This election has implications for both the external apparent authority on behalf of the LLC and the internal decision-making mechanism of the LLC. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.135 (LEXIS through 2013 1st Extra Sess.); *id*. § 275.165; VA. CODE ANN. § 13.1-1021.1(B)(1) (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.); *id*. §§ 13.1-1022. *See generally* Thomas E. Rutledge, *The Lost Distinction Between Agency and Decisional Authority: Unfortunate Consequences of the Member-Managed Versus Manager-Managed Distinction in the Limited Liability Company*, 93 KY. L.J. 737 (2005). RULLCA, unlike its predecessor, does not require a designation of whether the LLC is "member-managed" or "manager-managed" and does not condition agency authority on behalf of the LLC upon the designation. *See* RULLCA § 301, 6B U.L.A. 469 (2008). *See also* Thomas E. Rutledge & Steven G. Frost, *RULLCA Section 301—The Fortunate Consequences (and Continuing Questions) of Distinguishing Apparent Agency and Decisional Authority*, 64 BUS. LAW. 37, 37–38(2008). For an analysis of member management and manager management structures in the LLC, see BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 7.01–.11; RIBSTEIN & KEATINGE, *supra* note 1, §§ 8.01–.16.

The statutory provisions for either a "member-managed" or a "manager-managed" LLC, as they relate to the inter-se decision-making function, are optional and non-exclusive models. Minnesota, North Dakota, and Tennessee, by statute, each provides an alternative management structure, namely a board-managed LLC. *See* MINN. STAT. ANN. § 322B.606 (LEXIS through 2014 Reg. Sess.); N.D. CENT. CODE § 10-32-69 (LEXIS through 2013 Reg. Sess.); TENN. CODE ANN. § 48-239-101 (LEXIS through 2013 Reg. Sess.). In each of those states, if the board-managed option is utilized, it may be customized in the operating agreement. In the other states, even though there is no statutory mechanism for board management, it may be provided for in the operating agreement. Even then, there is a nearly inexhaustible number of options that might be provided. For example, it could be provided that there will be any number of individuals who will bear the title of manager, and that while any individual manager has authority to bind the LLC up to a particular dollar threshold, any obligation in excess of that limit must be sanctioned by some threshold of the entire number of managers before the company is to be bound. Alternatively, it could be provided that there will be a board of directors, elected

- ☐ Member-managed
- ☐ Manager-managed
- ☐ Other[9]

D. Name of Registered Agent[10]:

- ☐ Law Firm Services Company
- ☐ Other:_____

E. Address of Registered Agent:_____

_____

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or appointed from time to time by the members, that has a general oversight responsibility for the LLC but whose individual constituent members do not, as members of the board of directors, have any agency authority to bind the LLC. Rather, the LLC will act through those persons who are granted specific authority with respect to a particular transaction or through persons who have been afforded apparent agency authority to bind the LLC, such as through a title such as president, that indicates apparent agency to bind a business organization.

9. Tennessee, North Dakota and Minnesota fall outside of the general "member-managed" or "manager-managed" structures. Minnesota does not specifically authorize management of the LLC by its members, and it requires that each LLC have at least two managers, a chief executive manager and a treasurer. Minnesota LLCs have a board of governors that appoints the managers. MINN. STAT. § 322B.676 (LEXIS through 2014 Reg. Sess.). It should be noted, however, that the power to directly manage some or all aspects of the LLC may be reserved to the members pursuant to a control agreement (*id.* § 322B.37), and that any decisions that could be made by the managers may as well be taken by unanimous vote of the members (*id.* § 322B.606, subd. 2). Tennessee utilizes a structure under which LLCs are either member-managed or board-managed. TENN. CODE ANN. § 48-238-101 (LEXIS through 2013 Reg. Sess.). Where the LLC is board-managed, the members may override the decisions of the board by a two-thirds vote. *Id.* § 48-238-101(a)(3). North Dakota provides a board-managed structure where the board consists of one or more governors, N.D. CENT. CODE § 10-32-70 (LEXIS through 2013 Reg. Sess.), and may be elected by the organizers or named in the articles of organization or member-control agreement. *Id.* § 10-32-69(1). Members may, by unanimous vote, take any action that is permissible or required by the board. *Id.* § 10-32-69(2). Members may, subject to exceptions, remove any one or all governors with or without cause by majority vote. *Id.* § 10-32-78(3).

10. Every LLC act requires the designation by the company of a registered agent. *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-201(a)(2) (LEXIS through 2014 Fiscal Sess.); IND. CODE § 23-18-2-4(b)(2) (LEXIS through 2013 Reg. Sess. and 2013 1st Reg. Tech. Sess.); *id.* § 23-18-2-10; KY. REV. STAT. ANN. § 275.115 (LEXIS through 2013 1st Extra Sess.); TEX. BUS. ORGS. CODE ANN. § 5.201 (LEXIS through 2013 3d Called Sess.); WIS. STAT. § 183.0105(1) (LEXIS current through Act 117, dated January 16, 2014); *see also* RPLLCA § 201(a)(2), *supra* note 5, at 142; RULLCA § 113, 6B U.L.A. 452 (2008).

F. Principal address of LLC[11]: _____

_____

_____

G. Name and address of Organizer (Authorized Person)[12]:

☐ Law Firm Services Company

☐ Other [include address]: _____

H. Effective date of organization[13]: _____

11. Depending upon the specifics of state law, the principal office address may be a post office box or, in the alternative, it may be required that it be a street address. If, at the time this checklist is being completed, a determination as to the state of organization has not yet been finalized, the best practice may be to get both the street and, if different, the mailing address that will be the principal address of the LLC.

12. Most states provide that the organizer/authorized person need not be a member, but most states require that there be, at the time the LLC is formed, at least one member. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.020(1) (LEXIS through 2013 1st Extra Sess.); UTAH CODE ANN. § 48-2c-401(2)(a)(i) (LexisNexis 2010); *see also* RPLLCA § 201(b)(2), *supra* note 5, at 142. Virginia permits the formation of an LLC that lacks, at the time of formation, a member (a so-called "shelf LLC"). While RULLCA provides for a shelf LLC (RULLCA § 201(d), 6B U.L.A. 456 (2008)), no state has to date adopted that uniform language. Delaware does not require a member at the time of filing of the certificate of formation. *See* DEL. CODE ANN. tit. 6, § 18-201(d) (LEXIS through 2014 Fiscal Sess.); ConnectU LLC v. Zuckerberg, 482 F. Supp. 2d 3, 21 (D. Mass. 2007).

13. Typically, the LLC will be deemed formed upon the filing of the articles of organization. *See*, *e.g.*, KY. REV. STAT. ANN. § 14A.2-070 (LEXIS through 2013 1st Extra Sess.); *id.* § 275.020(2); MD. CODE ANN., CORPS & ASS'NS § 4A-202(b) (LEXIS Emergency Legis. through 2013 2d Reg. Sess.); TEX. BUS. ORGS. CODE ANN. § 3.001(c)(d) (LEXIS through 2013 3d Called Sess.); RPLLCA § 201(b)(1), *supra* note 5, at 142; RULLCA § 201(d)(1), 6B U.L.A. 456 (2008). Most, if not all, states allow the filing of documents, including articles of organization, with a delayed effective date. *See*, *e.g.*, FLA. STAT. ANN. § 608.409(2) (LEXIS through 2013 Reg. Sess.) (delayed effective date for a document may not be later than the 90th day after the filing date); KY. REV. STAT. ANN. § 14A.2-070(2) (LEXIS through 2013 1st Extra Sess.) (allowing a filed document to have a delayed effective date not later than the 90th day after the filing); N.Y. LTD. LIAB. CO. LAW § 203(d) (Consol. 2014) (allowing a filed document to have a delayed effective date not to exceed 60 days after the filing date); TEX. BUS. ORGS. CODE ANN. §§ 4.052–4.053 (LEXIS through 2013 3d Called Sess.); RPLLCA § 205(d)(3)(B), *supra* note 5, at 145. In Virginia, a company is deemed organized upon the issuance of a certificate of organization by the Virginia State Corporation Commission. VA. CODE ANN. § 13.1-1004.B (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.). The Delaware act requires there to be a limited liability company agreement to complete the formation process but allows a limited liability company agreement to be entered into after the filing of a certificate of formation and to be made effective as of the formation or at some other time or date as provided in the limited liability company agreement. DEL. CODE ANN. tit. 6, § 18-201(d) (LEXIS through 2014 Fiscal Sess.).

Federal tax principles, rather than state LLC law, determine the time at which a "partnership" comes into existence for federal tax purposes. One influential decision notes, "A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses." Comm'r v. Tower, 327 U.S. 280, 286 (1946); *see also* Torres v. Comm'r, 88 T.C. 702, 736 (1987); Sparks v. Comm'r, 87 T.C. 1279, 1282 (1986) ("A partnership is formed when the parties to a venture join together capital or services with the intent of conducting presently an enterprise or business."). Accordingly, other than the confusion of having the date of the operating agreement differ from the date of the LLC's formation, there should be no substantive difference between dating the agreement as of the date it is signed or as of the date of its formation when the LLC does not conduct any business or engage in any activities during the period between those two dates. An ar-

I. Professional LLC[14]: ☐ Yes ☐ No

J. Formed by conversion or merger[15]: ☐ Yes ☐ No

K. Other mandatory provisions[16]: _____

_____

gument exists, however, during the interim period that the state's default rules govern and may result in unintended consequences for that time period.

14. California allows the use of the LLC for structuring a professional practice except for the professions of law and medicine. CAL. CORP. CODE § 17375 (LEXIS (with urgency legislation) through ch. 31 of the 2014 Sess. and Propositions 41 & 42 approved June 2014). All other states allow the use of the LLC for legal and medical practices and other professions. For the state or states at issue, check the LLC act for what is a "profession." *See*, *e.g.*, FLA. STAT. ANN. § 621.03(3) (LEXIS through 2013 Reg. Sess.); KY. REV. STAT. ANN. § 275.015(25) (LEXIS through 2013 1st Extra Sess.); TEX. BUS. ORGS. CODE ANN. § 301.003(8) (LEXIS through 2013 3d Called Sess.). Some states require additional information in the articles of organization of a professional LLC. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.025(3) (LEXIS through 2013 1st Extra Sess.) (profession or professions to be practiced through LLC); TENN. CODE ANN. § 48-249-1103(a)(2)–(3) (LEXIS through 2013 Reg. Sess.) (that LLC is a professional LLC and that it has one or more professional owners and no non-professional members); TEX. BUS. ORGS. CODE ANN. § 3.014 (LEXIS through 2013 3d Called Sess.) (that the entity is a professional LLC and the type of professional service to be provided). In forming a professional LLC, care must be taken to address compliance with professional regulatory rules that affect structure and ownership. *See*, *e.g.*, KY. REV. STAT. ANN. §§ 325.301(1)(a), (c) (LEXIS through 2013 1st Extra Sess.). In some states, the name of a professional LLC must include the word "professional" or an appropriate abbreviation in its name. *See* FLA. STAT. ANN. § 621.12(2)(b)(2) (LEXIS through 2013 Reg. Sess.); KY. REV. STAT. ANN. § 14A.3-010(3) (LEXIS through 2013 1st Extra Sess.); N.C. GEN. STAT. § 48-248-301 (a)(1) (LEXIS through 2013 Reg. Sess.); TEX. BUS. ORGS. CODE ANN. § 5.059 (LEXIS through 2013 3d Called Sess.). *Contrast* N.Y. LTD. LIAB. CO. LAW § 1212 (Consol. 2014) ("professional" not required to be in the name of a professional service limited liability company).

15. Certain state laws allow an LLC to be formed by the conversion of an existing general partnership, limited partnership, or corporation. *See*, *e.g.*, FLA. STAT. ANN. § 608.439 (LEXIS through 2013 Reg. Sess.); GA. CODE ANN. § 14-2-1109.1 (LEXIS through 2014 Reg. Sess.); *id.* § 14-11-212; KY. REV. STAT. ANN. § 275.370 (LEXIS through 2013 1st Extra Sess.); *id*. §§ 275.375, 275.376 MD. CODE ANN., CORPS. & ASS'NS § 4A-211 (LEXIS Emergency Leg. through 2013 2d Reg. Sess.); RPLLCA § 1005, *supra* note 5, at 205; RULLCA, § 1006, 6B U.L.A. 532 (2008); TENN. CODE ANN. § 48-249-104 (LEXIS through 2013 Reg. Sess.); TEX. BUS. ORGS. CODE ANN. § 10.101 (LEXIS through 2013 3d Called Sess.); VA. CODE ANN. § 13.1-1010.1 (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.). Maryland and Rhode Island as well permit the conversion of a sole proprietorship into an LLC. MD. CODE ANN., CORPS. & ASS'NS § 4A-212 (LEXIS Emergency Leg. through 2013 2d Reg. Sess.); R.I. GEN. LAWS § 7-16-5.1 (LEXIS through 2013 Reg. Sess.). As contrasted with the merger of an existing business entity into an LLC, in a conversion (i) at any moment there exists only one business entity, (ii) there having been no merger, "due on merger" clauses are not triggered, and (iii) the converted entity is the same entity as that which existed before the conversion. *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-214 (LEXIS through 2014 Fiscal Sess.); FLA. STAT. ANN. § 608.4404 (LEXIS through 2013 Reg. Sess.); KY. REV. STAT. ANN. § 275.375 (LEXIS through 2013 1st Extra Sess.); RPLLCA § 1008, *supra* note 5, at 208; VA. CODE. ANN. § 13.1-1010.2 (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.).

16. The requirements for the articles/certificate are state-specific and need to be satisfied. For example, a state may require that they list the initial members or initial managers. *See*, *e.g.*, NEV. REV. STAT. § 86.161(1)(d) (LEXIS through 2013 Reg. and Special Sess.).

L. Other non-mandatory provisions[17]:_____

_____

_____

M. Waivers of limited liability[18]: ☐ Yes ☐ No

N. Operating agreement to be signed by LLC[19]: ☐ Yes ☐ No

17. Many LLC acts permit the articles of organization to contain provisions that are not required to be included. *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-201(a)(3) (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.025(4) (LEXIS through 2013 1st Extra Sess.); RPLLCA § 201(a)(5), *supra* note 5, at 142; TEX. BUS. ORGS. CODE ANN. § 3.005(b) (LEXIS through 2013 3d Called Sess.). However, although the states may permit additional information in the articles, they have different rules for whether those provisions, simply by filing with the Secretary of State, constitute notice to third parties who are not otherwise aware. *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-207 (LEXIS through 2014 Fiscal Sess.) (only those provisions of the certificate of formation setting forth the name, the registered agent/office, and whether the LLC is a series LLC constitute notice by filing with the Secretary of State's office); KY. REV. STAT. ANN. § 275.025(7) (LEXIS through 2013 1st Extra Sess.) (articles of organization on file with the Secretary of State are notice that an LLC is organized under Kentucky law and of all other facts set forth therein that are required to be set forth in the articles); N.H. REV. STAT. ANN. § 304-C:16 (LEXIS through 2013 Reg. Sess.) (certificate of formation on file with the Secretary of State is notice that the entity has been formed as an LLC "and is notice of all other facts set forth in the certificate which are required to be set forth by RSA 304-C:12II(a), (b), and (c)"); *see also* Zions Gate R.V. Resort, LLC v. Oliphant, 326 P.3d 118 (Utah Ct. App. 2014). For a discussion of optional contents in the articles of organization, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 5.05[3]; RIBSTEIN & KEATINGE, *supra* note 1, § 4:08. New York has an additional requirement that the articles of organization be published in two newspapers for six weeks and that the LLC file proof of that publication with the department of state. N.Y. LTD. LIAB. CO. LAW § 206 (Consol. 2014).

18. Several of the LLC acts expressly permit the members, by a provision in the articles of organization, to waive their limited liability either in total or with respect to certain obligations. Other LLC acts allow that election to be set forth in either the articles of organization or in another written agreement. *See*, *e.g.*, KAN. STAT. ANN. § 17-7688(b) (LEXIS through 2013 Reg. Sess.); KY. REV. STAT. ANN. § 275.150(2) (LEXIS through 2013 1st Extra Sess.); TEX. BUS. ORGS. CODE ANN. § 101.114 (LEXIS through 2013 3d Called Sess.); *id.* § 101.051. It is unusual for LLC members to waive limited liability completely. It is more common, however, for LLC members to guarantee some or all of the LLC debt or to agree to a limited obligation to restore a deficit capital account. Besides the obvious economic consequences, a guarantee of debt or deficit restoration obligation can have important tax consequences, including consequences under Code § 465 ("at risk" rules) and Code § 752 (LLC debt included in member's basis).

19. There is some question regarding whether the LLC is bound by the operating agreement if the LLC fails to execute the operating agreement. *Contrast* Tover v. 419 OCR, Inc., 921 N.E.2d 1249, 1254–55 (Ill. App. Ct. 2010) (LLCs not bound by arbitration clauses in operating agreement because LLC is not a party to operating agreement); Bubbles & Bleach, LLC v. Becker, No. 97 C 1320, 1997 U.S. Dist. LEXIS 7471, at *6 (N.D. Ill. May 16, 1997) (LLC not bound by arbitration clause in operating agreement); *In re* Am. Media Distribs., LLC, 216 B.R. 486, 487 (Bankr. S.D.N.Y. 1998) (LLC is not a party to operating agreement and therefore bankrupt LLC cannot assume operating agreement); Mission Residential, LLC v. Triple Net Props., LLC, 654 S.E.2d 888, 891 (Va. 2008) (arbitration clause in operating agreement did not require arbitration of a member's derivative claim because the claim belonged to the LLC, and as the LLC was itself not a party to the operating agreement, it did not mandate the arbitration of a derivative claim (subsequently overruled by amendment), *with* Elf Atochem North Am., Inc. v. Jaffari, 727 A.2d 286, 293 (Del. 1999) (though not a party, LLC bound by choice of forum and arbitration clauses in operating agreement). The Delaware LLC act now specifically provides that a LLC need not sign the limited liability company agreement to be "bound by it." DEL. CODE ANN. tit. 6, § 18-101(7) (LEXIS through 2014 Fiscal Sess.); *see also* KY. REV. STAT. ANN. § 275.003(4) (LEXIS through 2013 1st Extra Sess.); OHIO REV. CODE ANN. 1705.081(A) (LexisNexis 2001 & Supp. 2013); RULLCA § 111(a), 6B U.L.A. 449 (2008) ("A limited liability company is bound by and may enforce the operating agreement, whether or not the company has itself manifested assent to the op-

O. Operating agreement to be signed by Managers[20]:

☐ Yes ☐ No ☐ N/A

P. Company Communication Agent[21]:_____

erating agreement."); RPLLCA § 111(a), *supra* note 5, at 138. For an analysis suggesting that a Delaware LLC, before the statutory amendment described, had standing to enforce its LLC agreement without being a party, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 14.02[8][a][ii]. Most LLC acts are silent on the issue. By the act providing that a Delaware LLC that does not sign the operating agreement is "bound" by it, if reference is made in the operating agreement or in another agreement to the "parties" of the operating agreement, should that include the LLC itself? The drafter should be cognizant of this question and provide appropriate clarification. Perhaps the easiest way to deal with this question is to have the LLC sign the operating agreement, thereby clearly making it a "party" to the operating agreement; then, if a reference to the parties of the operating agreement is not intended to include the LLC itself, a statement or carve-out to that effect may be provided.

20. Under most statutory formulations, the operating agreement is entered into by and among the members. *See*, *e.g.*, IND. CODE § 23-18-1-16 (LEXIS through 2013 Reg. Sess. and 2013 1st Reg. Tech. Sess.); KY. REV. STAT. ANN. § 275.015(20) (LEXIS through 2013 1st Extra Sess.); VA. CODE ANN. § 13.1-1002 (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.). At the same time, third parties to the operating agreement may be made beneficiaries of the agreement (*see*, *e.g.*, KY. REV. STAT. ANN. § 275.003(3) (LEXIS through 2013 1st Extra Sess.); RPLLCA § 112(b), *supra* note 5, at 139), and by necessary implication a manager is obligated to discharge its authority in accordance with the operating agreement. To that end, it may be appropriate to require the managers, if not already members, to agree to be bound in the discharge of their services by the operating agreement. Care should be taken to insure, unless it is the desired outcome, that the consent of the managers to subsequent amendments to the operating agreement do not require their consent. A manager may want protection against a retroactive modification of the operating agreement impacting his or her rights and obligations.

21. Certain acts require the LLC to identify to its registered agent a "communications contact" authorized to receive communications on behalf of the LLC from the registered agent. *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-104(g) (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 14A.4-010(3) (LEXIS through 2013 1st Extra Sess.). Even when not required by statute, most commercial registered agent companies will ask the LLC to identify a person filling the role of the communications contact.

PART III. Identification of Members[22]

A. Members[23]:

22. Generally, limited liability companies are governed by contract (*see*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-1101 (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.003(1) (LEXIS through 2013 1st Extra Sess.)), and that contract is typically denominated the "operating agreement," although in certain states it is referred to as the "company agreement" (TEX. BUS. ORGS. CODE ANN. § 101.001(1) (LEXIS through 2013 3d Called Sess.)), the "member control agreement" (*see* MINN. STAT. § 322B.37 (LEXIS through 2014 Reg. Sess.); N.D. CENT. CODE § 10-32-50 (LEXIS through 2013 Reg. Sess.)), or the "limited liability company agreement." DEL. CODE ANN. tit. 6, § 18-101(7) (LEXIS through 2014 Fiscal Sess.); RPLLCA § 102(14), *supra* note 5, at 129. As LLC acts typically serve as gap fillers where there exists no written operating agreement, with respect to any critical point at issue, it is crucial that an operating agreement be drafted that reflects the agreement of the parties. As observed by the Delaware Chancery Court, "LLC members' rights begin with and typically end with the Operating Agreement." Walker v. Res. Dev. Co., 791 A.2d 799, 813 (Del. Ch. 2000). When drafting an operating agreement, one should be mindful of the observation made by Vice Chancellor Strine in *Kronenberg v. Katz*, 872 A.2d 568, 593 (Del. Ch. 2004), that "murkiness" of the language of an operating agreement, particularly with respect to modifying traditional fiduciary duties, often "is fatal." Then Vice Chancellor Strine has warned investors in alternative entities that they will be held to the terms of the contract into which they enter:

> This Court has made clear that it will not [be] tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA [(as does the DLLCA)] puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock.

Miller v. Am. Real Estate Partners, L.P., No. 16788, 2001 Del. Ch. LEXIS 116, at *26–27 (Del. Ch. Sept. 6, 2001) (footnotes omitted).

23. Part III of this Checklist ("Identification of Members") is the place to list the owners of the LLC, but do not read too much into the term "member." "Membership" can mean almost anything the parties want it to mean. LLC membership usually entails some combination of financial (equity ownership) and nonfinancial (governance) rights, but there are exceptions. In some states it is possible for the LLC to have a "member" lacking any financial rights. *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-301(d) (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.195(3) (LEXIS through 2013 1st Extra Sess.). Typically those provisions are utilized to create protective provisions. For example, a lender could insist upon its appointment of a non-economic member and that the operating agreement require the approval of all members for its amendment. *See also* RULLCA § 112(a), 6B U.L.A. 449 (2008).

In most instances, each "member" of the LLC will be treated as a "partner" (or owner or member) for tax purposes. Even if the LLC is classified as a partnership for tax purposes, however, the "members" of the LLC under applicable state law may not be the same as the "partners" for tax purposes. While an assignee of a member's entire economic interest in the LLC will not necessarily be a "member" for purposes of state law, that same assignee will often be treated for tax purposes as a "partner" in the venture. *See* Rev. Rul. 77-137, 1977-1 C.B. 178. Conversely, a state law member lacking an economic interest in the LLC would not be treated as a partner for tax purposes. *See* I.R.S. Priv. Ltr. Rul. 200201024 2(Oct. 5, 2001). *See generally* Paul D. Carman & Colleen A. Kushner, *The Uncertain Certainty of Being a Partner: Partner Classification for Tax Purposes*, J. TAX'N, Sept. 2008, at 165.

Name	United States Person[24] Yes No
	State(s) of Residence or in Which Taxable[25]:
If entity, form of entity, jurisdiction of organization, and tax status[26]:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

[Use attached list if more than six members]

24. The LLC and its advisors are charged with reviewing the list of the Office of Foreign Assets Control ("OFAC list") (money laundering and terrorist rules) to insure that business is not conducted with a prohibited person. The OFAC within the United States Department of the Treasury enforces various economic and trade sanctions and maintains the Specially Designated Nationals List ("SDN List"); it is available at OFAC's website. United States citizens and companies, subject to certain exclusions typically conditioned upon the issuance of a special license, are precluded from engaging in business with any person or entity listed on the SDN List. For more information and OFAC guidance, see the OFAC website at www.treasury.gov/about/organizational-structure/officers/pages/office-of-foreign-assets-control.espx. *See also* ABA Comm. on Ethics & Prof'l Responsibility, ABA Formal Op. 463 (May 23, 2013).

The LLC may have special withholding tax obligations with respect to members who are not U.S. persons unless those members are otherwise subject to U.S. tax on income allocated to them from the LLC. A U.S. person, as defined in 26 U.S.C. § 7701(a)(30) (2012), means: (i) a citizen or resident of the United States; (ii) a partnership or corporation created or organized in the United States or under the laws of the United States or any state; (iii) an estate the income of which is subject to U.S. federal income taxation regardless of source; or (iv) a trust if a U.S. court is able to exercise primary supervision over the administration of the trust and one or more U.S. persons has the authority to control all substantial decisions of the trust (and certain other trusts in existence on August 20, 1996). Withholding of tax with respect to foreign partners can be burdensome for the LLC, and some LLCs try to avoid having foreign partners. Code § 1446 generally requires quarterly withholding on a foreign partner's allocated share of income "effectively connected" with a U.S. trade or business, even if distributions are not made to the foreign partner. *Id.* § 1446. This requirement can create cash flow problems, particularly if the LLC engages in a transaction that generates "effectively connected" income but no cash. *Id.* Section 1445 may require the LLC to withhold tax on gain allocable to foreign partners when the LLC disposes of an interest in U.S. real property (including an interest in a "U.S. real property holding corporation"). An LLC may also be required to withhold on "fixed or determinable annual or periodical" ("FDAP") income (for example, interest, dividends, rent, or royalties) allocable to foreign partners regardless of whether the LLC makes distributions to the foreign partners. *See* Treas. Reg. § 1.1441-5(b)(2)(i)(A) (2001). Non-U.S. persons may be entitled to reduction or elimination of withholding on certain kinds of income under the extensive tax treaty network that the U.S. has with other countries. The operating agreement should specify the parties' intended treatment of amounts withheld on behalf of a member (whether to pay federal tax or, as noted below, to pay state or local tax). Under many operating agreements, the amount withheld reduces, dollar for dollar, distributions (including so-called "tax distributions") to which the member otherwise is or may later become entitled. Other agreements, however, treat the amount as a loan, which the member must repay to the LLC, or as an increase in the amount of capital that the member must contribute to

the LLC. Some agreements give the LLC manager the discretion to choose the way the LLC will treat withheld taxes.

25. Most states assert the right to tax nonresident members of the LLC by reason of the LLC's business or property in the state. The states have taken different approaches to the enforcement of this taxing jurisdiction. Approaches include having the LLC: (i) obtain a signed consent from nonresident members to pay income tax to that state on their share of the LLC's income, relieving the LLC of an obligation to make tax payments in respect of a nonresident member; (ii) withhold (and pay over to the state) income tax on the nonresident members' share (withholding is the term used even if there are no distributions from which to withhold); or (iii) file a composite return and remit tax on the members' share. A single state may combine different approaches. In California, the LLC's obligation to pay tax on behalf of a nonresident member is triggered only if the member fails to provide a consent to file individually in California. CAL. REV. & TAX. CODE § 18633.5(e) (LEXIS (with urgency legislation) through Ch. 31 of the 2014 Sess. and Propositions 41 & 42 approved June 2014). In Georgia, the LLC must withhold at the rate of 4 percent on Georgia income distributed or "credited" to a nonresident, or, in the alternative, must file a composite return and remit the tax shown on the composite return. GA. CODE ANN. § 48-7-129 (LEXIS through 2014 Reg. Sess.). A member of a multistate LLC may face a severe compliance burden if the member must file a tax return in every state in which the LLC does business. Almost all states that impose income tax on partners now permit (or, in some instances, require) "composite returns" in which the LLC files a return and remits the taxes on behalf of the nonresident members. Amounts that the LLC withholds, or remits with the composite return, are credited against the member's tax liability in that state. In some instances, but not all, the member may be entitled to file for a refund of overpayments. States have different methods for determining how much of an LLC's income is allocated or apportioned to that state. Although the LLC member's home state usually subjects the member to tax on his or her entire share of the LLC's income—without regard to how much of that income is allocated or apportioned to that state—the problem of double taxation tends to be greatly reduced, but not necessarily eliminated, by credits that the member's home state gives for taxes paid to other states. *See*, *e.g.*, Patrick H. Smith & Michael W. McLoughlin, *State Non-Resident Composite Income Tax Returns Can Provide Simplicity But at a Cost*, BUS. ENTITIES, Nov./Dec. 2004, at 26; BISHOP & KLEINBERGER, *supra* note 1, ¶ 1.07[4]; RIBSTEIN & KEATINGE, *supra* note 1, § 16:10. Certain states have adopted, for state law purposes, provisions patterned on the federal "FIRPTA" withholding requirements. *See*, *e.g.*, CAL. REV. & TAX. CODE § 18662 (LEXIS (with urgency legislation) through Ch. 31 of the 2014 Sess. and Propositions 41 & 42 approved June 2014). State withholding can raise the same issues—cash flow problems and the treatment of amounts paid on behalf of a member—noted above in connection with federal withholding.

26. The LLC may need or want to know whether the member is itself a pass-through entity, or whether it is a tax-exempt entity (and if so what tax-exempt status it has). For example, if the member is a tax-exempt entity, the LLC may be required to report "unrelated business taxable income" ("UBTI") to the member. *See* 26 U.S.C. §§ 511–514 (2012). Some tax-exempt organizations (primarily educational institutions and pension plans) enjoy a special exemption from certain UBTI where the LLC invests in debt-financed real property but are subject to some of the most complicated requirements in all of tax law. *See id.* § 514(c)(9). The presence of tax-exempt members sometimes affects tax consequences to other LLC members. *See id.* §§ 168(h)(6), 470; See BISHOP & KLEINBERGER, *supra* note 1, ¶ 1.09 an (analysis of joint ventures between exempt and for-profit organizations).

Member #2

Name:	United States Person: Yes No
	State(s) of Residence or in Which Taxable:
If entity, form of entity, jurisdiction of organization, and tax status:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

Member #3

Name:	United States Person: Yes No
	State(s) of Residence or in Which Taxable:
If entity, form of entity, jurisdiction of organization, and tax status:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

Member #4

Name:	United States Person: Yes No
	State(s) of Residence or in Which Taxable:
If entity, form of entity, jurisdiction of organization, and tax status:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

Member #5

Name:	United States Person: Yes No
	State(s) of Residence or in Which Taxable:
If entity, form of entity, jurisdiction of organization, and tax status:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

Member #6

Name:	United States Person: Yes No
	State(s) of Residence or in Which Taxable:
If entity, form of entity, jurisdiction of organization, and tax status:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

- ☐ If a member is a trust, provide name of trustee and date of document creating trust, and whether trust is revocable or irrevocable.[27]
- ☐ If a member is an estate, provide name of legal representative, date of death if applicable, and certified copy of appointing court order.
- ☐ If agent, provide name of principal, copy of appointing document, and affidavit of effect.
- ☐ Is any member an affiliate of any other member or manager?
- ☐ Identify other relationships between Members and/or Manager (personal, family, other business relationships).

B. Tax classification:

1. Is this a single-member LLC?[28] ☐ Yes ☐ No
2. LLC to be taxed under[29]:
   - ☐ Subchapter K[30]

27. The trust document must be reviewed in order to establish that membership in an LLC, and the anticipated business activities, are permitted under the trust document and the trustee's scope of authority. The trust document will also provide who has authority to bind the trust.

28. All states now permit the formation of a single-member LLC. *See*, *e.g.*, RIBSTEIN & KEATINGE, *supra* note 1, § 4:3. A single-member LLC is generally simple to organize and many of the items on this checklist will be unnecessary, including, for example, requirements for given levels of member approval of decisions, or items presupposing that the LLC is a partnership for tax purposes, e.g., capital account maintenance.

29. Note that this question addresses only federal tax classification. Some states impose an entity-level tax on business structures that, for federal tax purposes, are pass-through entities. *See generally* KEATINGE & CONAWAY, *supra* note 1, §§ 5.1–.26; BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 3.01–.12; RIBSTEIN & KEATINGE, *supra* note 1, § 16:10. Many states that follow the federal classification for income tax purposes diverge from the federal classification for purposes of other taxes, such as sales and use tax. The Georgia LLC act, for example, follows the federal classification rules only for "income" tax purposes. GA. CODE ANN. § 14-11-1104 (LEXIS through 2014 Reg. Sess.).

- ☐ Subchapter C[31]
- ☐ Subchapter S[32]
- ☐ Other[33]

C. OFAC compliance:

1. Confirmation that no initial Manager or beneficial owner is on Office of Foreign Asset Control (OFAC) Specially Designated Nationals (SDN)

30. For purposes of federal income tax classification, a limited liability company is an "eligible entity" as defined in the so-called "Check-the-Box" classification regulations, meaning that it is eligible to choose either corporation or non-corporation classification. LLCs are not specifically mentioned in the Check-the-Box regulation. The reason LLCs are generally eligible to choose their own tax classification is simply because they are not formed under a statute that "describes or refers to [them] as incorporated or as a corporation, body corporate, or body politic." Treas. Reg. § 301.7701-2(b)(1) (as amended in 2014). An LLC or other business entity that is taxable as a corporation under some provision of the Code other than Code § 7701(a)(3), however, is not eligible to select another classification. Treas. Reg. § 301.7701-2(b)(7) (as amended in 2014). Most importantly, any entity—LLC, partnership, or otherwise—will be ineligible if it is a "publicly traded" entity that is required to be treated as a corporation under Code § 7704. 26 U.S.C. § 7704 (2012). In addition to many publicly traded entities, some of the other categories of businesses that are ineligible—and will always be classified as corporations—include insurance companies, state-chartered banks holding federally insured deposits, certain government-owned entities, certain foreign entities, and entities claiming federal tax-exempt status. Assuming that an LLC is an "eligible entity" and it has two or more members, it will have a default classification as a "partnership" and will be governed by Subchapter K of the Internal Revenue Code. Where the LLC is an eligible entity and has only a single member, it will have a default classification as a "disregarded entity." Treas. Reg. § 301.7701-2 (as amended in 2014). As noted above, a member or "partner" for tax purposes is not necessarily the same as a "member" under applicable LLC law. Most (not all) multi-member LLCs will be classified as partnerships for tax purposes. Unless otherwise noted, comments in this checklist relating to the tax treatment of the LLC and its members assume that the LLC will be treated as a partnership and that the members will be treated as partners.

31. In almost every case, a limited liability company not otherwise required to be taxed as a corporation may elect to be taxed as a corporation. The election is made by filing a Form 8832 with the IRS. Essentially, the only limitation on an LLC's eligibility to be classified as a corporation is that an LLC (or other entity) generally may change its election once every sixty months (although an election by a new entity effective on the date of formation does not count as a change). *Id.* § 301.7701-3(c)(1)(iv). The LLC's election must be signed by all the members or "any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election." *Id.* § 301.7701-3(c)(2)(i).

32. If the LLC seeks to be an S corporation under Code § 1361, it will file a Form 2553. When S corporation status is desired, the Form 2553 will accomplish both the election to be classified as an association taxable as a corporation and the election under Code § 1361, and the Form 8832 need not be filed. *Id.* § 301.7701-3(c)(1)(v)(C). Many LLCs will be ineligible for S corporation status. For example, if even one of the members of the LLC is a corporation or another LLC that is classified as a partnership, eligibility is lost. 26 U.S.C. § 1361(b)(1)(B) (2012). Furthermore, an LLC that seeks S corporation status will be subject to the one class of stock rule of CODE § 1361(b)(1)(D). *See also* Thomas E. Rutledge, *S Corp. LLCs—Planning Opportunity or Solution in Search of a Problem?*, J. PASS-THROUGH ENTITIES, July/Aug. 2012, at 37.

33. There are many "other" possibilities, although they do not commonly arise. For example, in some cases an LLC may be able to elect classification as a cooperative and taxation under Subchapter T. While it does not appear the issue has been directly addressed by the IRS, the consensus answer appears to be that an LLC, otherwise taxed under Subchapter K, in most circumstances may not make an election out of Subchapter K under Code § 761. *See generally* RIBSTEIN & KEATINGE, *supra* note 1, § 17:20; BISHOP & KLEINBERGER, *supra* note 1, ¶ 2.10. Certain LLCs owned by a husband and wife will not be treated as partnerships. *See* 26 U.S.C. § 761(f) (2012).

List. ☐ Yes ☐ No

Date of list: _____

2. Responsibility for checking SDN upon admission of additional Member(s):

   ☐ Manager

   ☐ All Members

   ☐ Legal Counsel

   ☐ Other: _____

PART IV. General Provisions

A. General provisions:

1. Effective date of operating agreement: _____, 20__.[34]

2. Statement of LLC's purpose[35]: _____

_____

_____

_____

_____

34. Assuming this is the initial operating agreement, the effective date is usually the effective date of the filing of the articles of organization, unless a different date is desired. Care should be taken in determining when the operating agreement is effective to avoid a gap in the understanding and agreement of the parties. Some state statutes deem an operating agreement to exist as of the date of organization of the LLC and other statutes do not.

35. It is all too easy to take comfort in statutory provisions to the effect that the business at issue may be used for "any lawful business" (*see*, *e.g.*, RULLCA § 104(b), 6B U.L.A. 437 (2008); RPLLCA § 105(a), *supra* note 5, at 132; KY. REV. STAT. ANN. § 275.005 (LEXIS through 2013 1st Extra Sess.)) and assume that purpose limitations are no longer a concern for modern business organizations. That comfort is unjustified. In fact, an array of proper purpose limitations exist, and there are a number of statutes that expressly remind practitioners that these other limitations on proper purpose must be considered. For example, Kentucky law provides that "if the purpose for which a limited liability company is organized or its activities make it subject to special provisions of law, the limited liability company shall also comply with those provisions." KY. REV. STAT. ANN. § 275.005 (LEXIS through 2013 1st Extra Sess.); *see also* S.D. CODIFIED LAWS § 47-34A-112(a) (LEXIS through all 2013 leg. passed at the 88th Reg. Sess., including Supreme Court Rule 14-10 and November 2012 ballot measures); VT. STAT. ANN. tit. 11, § 3012(b) (LEXIS through the 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.). This issue can also arise where a foreign business organization, engaged in a permissible activity in its jurisdiction of organization, engages in an activity in a foreign jurisdiction in which it is not permitted to so act. *See*, *e.g.*, RULLCA § 801(c), 6B U.L.A. 515 (2008) ("A certificate of authority does not authorize a foreign limited liability company to engage in any business or exercise any power that a limited liability company may not engage in or exercise in this State."); RPLLCA §§ 801(c), (d), *supra* note 5, at 185; KY. REV. STAT. ANN. § 275.380 (2) (LEXIS through 2013 1st Extra Sess.) ("A certificate of authority obtained pursuant to this chapter shall not authorize a foreign limited liability company to exercise any powers or engage in any business that a domestic limited liability company is forbidden to exercise or engage in by the laws of this Commonwealth."); S.D. CODIFIED LAWS § 47-34A-1001(c) (LEXIS through all 2013 leg. passed at the 88th Reg.

3. Fiscal year[36]:

   ☐ Calendar year
   ☐ Other: _____

4. Assumed name filings[37]:

Name	File in State(s)
Name	File in State(s)

B. Financial statements; accountant; accounting method; audits:

1. Financial statements to Members

   a. Regular financial reports provided to Members[38]

Sess., including Supreme Court Rule 14-10 and November 2012 ballot measures) ("A certificate of authority does not authorize a foreign limited liability company to engage in any business or exercise any power that a limited liability company may not engage in or exercise in this state."); TEX. BUS. ORGS. CODE ANN. § 9.201 (LEXIS through 2013 3d Called Sess.) ("A foreign entity may not conduct in this state a business or activity that is not permitted by this code to be transacted by the domestic entity to which it most closely corresponds."). For example, a railroad organized as an LLC may not transact business in Vermont. *See* VT. STAT. ANN. tit. 11, § 3012(b)(3) (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.). *See generally* Thomas E. Rutledge, *Limited Liability (or Not): Reflections on the Holy Grail*, 51 S.D. L. REV. 417, 439–42 (2006). For analysis of business purpose requirements including statutory restrictions on types of business, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 5.03; RIBSTEIN & KEATINGE, *supra* note 1, § 4:10. In addition to legal limitations, defining the purpose more narrowly will affect the manager's authority and whether a dissolution is appropriate because it is no longer reasonably practicable to carry on the business. *See*, *e.g.*, *In re* Seneca Invs., LLC, 970 A.2d 259, 266 n.29 (Del. Ch. 2008).

36. *See* 26 U.S.C. § 444 (2012) (regarding the availability of a taxable year other than the calendar year). In addition, an LLC classified for tax purposes as a partnership generally must have the same taxable year as partners having an aggregate interest in profits and capital of more than 50 percent. *See Id.* § 706(b)(1)(B).

37. If the LLC intends to conduct business using a name different from its "real name," it may be necessary to file a certificate of assumed name or similar document with the appropriate secretary of state. *See*, *e.g.*, FLA. STAT. ANN. § 865.09 (LEXIS through 2013 Reg. Sess.); KY. REV. STAT. ANN. § 365.015 (LEXIS through 2013 1st Extra Sess.) (regulating assumed names in general); *id.* § 14A.3-040 (regulating use of fictitious name by foreign LLC); TEX. BUS. & COM. CODE § 71.101 (LEXIS through 2013 3d Called Sess.).

38. This begs two questions—what is "regular" and what are the "financial reports"? The answer to each will depend upon the deal in question. Disputes can be avoided by specifying that reports will be delivered within X days of identifiable dates such as the end of various fiscal periods. Disputes are further avoided by specifying whether certain documents (e.g., balance sheet, periodic profit and loss statement, profit and loss statement compared against budget, etc.) are incorporated into the definition of the financial statements that will be delivered. It may be appropriate as well to specify whether those financial statements will be prepared in accordance with U.S. generally accepted accounting principles ("GAAP"), or in accordance with other accounting standards such as International Financial Reporting Standards ("IFRS"). Audited financial statements are typically available only on an annual basis. Where it is anticipated that an audited report will be delivered on an annual basis, it may be appropriate to specify that other periodic reports will not be audited. Unless the LLC is a disregarded entity, the LLC is required to have a set of tax books. If the LLC is classified as a partnership for tax purposes, the LLC generally should maintain capital accounts in accordance with the applicable Treasury Regulations to pre-

b. Audited financial reports provided to Members
c. Any one or more of the foregoing provided to Members, but only upon Members' request (items _____)[39]

2. Accountant:

(Name) _____

(Firm) _____

(Address) _____

_____

_____

(Phone) _____

(Fax) _____

(E-mail) _____

pare its federal income tax returns. In many situations, the financial information prepared for tax purposes is sufficient. If, however, the parties believe that financial information prepared in accordance with tax accounting methods is insufficient, they may require that a separate set of books and records be maintained under U.S. GAAP or some other set of standards. A middle approach is to require that only tax books must be maintained but allow the manager or the members to cause the LLC to prepare financial statements in accordance with one or more other methods of accounting. Consider state-specific requirements with respect to the delivery of information and whether the operating agreement may modify those delivery obligations. *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-305(a) (LEXIS through 2014 Fiscal Sess.) (members of a limited liability company have the right to demand information, subject to reasonable standards "as may be set forth in a limited liability company agreement . . . for any purpose reasonably related to the member's interest as a member of the limited liability company," and subject to additional restrictions on obtaining information that may be imposed in accordance with section 18-305(g) of the Delaware LLC Act); KY. REV. STAT. ANN. § 275.185(3) (LEXIS through 2013 1st Extra Sess.) (requiring the affirmative delivery of information to members "to the extent the circumstances render it just and reasonable, true and full information of all matters affecting the members to any member").

39. Depending upon the LLC act under which the LLC is formed and the LLC's operating agreement, members may have a right to access records and information, including the right to inspect and copy, during ordinary business hours to the extent the information is material to the member's rights and duties under the operating agreement. *See*, *e.g.*, FLA. STAT. ANN. § 608.4101(2) (LEXIS through 2013 Reg. Sess.); RPLLCA § 408, *supra* note 5, at 160; RULLCA § 410, 6B U.L.A. 492 (2008); TEX. BUS. ORGS. CODE ANN. § 101.502 (LEXIS through 2013 3d Called Sess.). In other instances there is no requirement of a proper purpose but only that the request be "reasonable." *See*, *e.g.*, KY. REV. STAT. ANN. § 275.185(2) (LEXIS through 2013 1st Extra Sess.). This right presumably includes, but is not limited to, financial records of the company. Under certain statutes, the right to information may not be unreasonably restricted. *See*, *e.g.*, RULLCA § 110(c)(6), 6B U.L.A. 442 (2008). If the LLC is classified as a partnership for tax purposes, the IRS must allow "any person who was a member of such partnership during any part of the period covered by the return" to see the partnership return. 26 U.S.C. § 6103(e)(1)(C) (2012). *See generally* BISHOP & KLEINBERGER, *supra* note 1, ¶ 5.07; RIBSTEIN & KEATINGE, *supra* note 1, § 9:5.

3. Accounting method[40]:

   ☐ Cash
   ☐ Accrual

4. Audit or review:

Audit	Review
☐ Required	☐ Required
☐ At option of Managers	☐ At option of Managers
☐ At option of Members	☐ At option of Members
☐ Who shall bear cost	☐ Who shall bear cost

5. Certification of membership interests[41]: ☐ Yes ☐ No

C. Capital contributions[42]:

40. An LLC should discuss accounting methods with its accountant and tax advisor. In general, an LLC will have the same overall method for tax and financial accounting purposes (see the "conformity rule" of 26 U.S.C. § 446(a) (2012)), but there are exceptions. The two most common tax accounting methods are the "cash receipts and disbursements method" and the "accrual method." The cash method tends to be simpler, but the accrual method is considered more accurate and is more consistent with GAAP. Taxpayers sometimes have a choice in selecting their overall tax accounting method. *See id.* § 446(c). However, the taxing authorities tend to disfavor cash method reporting, and there are rules mandating the accrual method for many taxpayers, including certain C corporations, certain partnerships that have a C corporation as a partner, "tax shelters," and businesses required to maintain inventories. *See id.* § 448(a). Other accounting methods may be required or permitted depending on the nature of the LLC's activities. *See*, *e.g.*, *id.* § 460 (percentage of completion method required for many long-term manufacturing or construction contracts); *id.* § 475 (mark-to-market accounting required for dealers in securities).

41. Most, if not all, LLC acts expressly permit membership interests to be represented by a physical certificate. *See*, *e.g.*, GA. CODE ANN. § 14-11-501(b) (LEXIS through 2014 Reg. Sess.); KY. REV. STAT. ANN. § 275.255(2) (LEXIS through 2013 1st Extra Sess.). However, depending upon applicable state law and modifications to those definitions contained in the operating agreement, a certificate might evidence only a member's economic rights (*see*, *e.g.*, GA. CODE ANN. § 14-11-101(13) (LEXIS through 2014 Reg. Sess.); VA. CODE ANN. § 13.1-1002) (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.)) and not the entirety of the management rights that might be commonly perceived as being a component to a "membership interest." Note that, if it is desired that physical certificates be governed by and have the effect of a certificated security under Article 8 of the Uniform Commercial Code, it is necessary that a specific election to that effect be made in the operating agreement. Absent that election, interests in a limited liability company are general intangibles governed by Article 9 of the Uniform Commercial Code. *See generally* BISHOP & KLEINBERGER, *supra* note 1, ¶ 5.04[2][b][ii][C]; RIBSTEIN & KEATINGE, *supra* note 1, § 7:7.

42. Most LLC acts permit members' contributions to be made in any of a variety of forms, including cash, property, services rendered, promissory notes, agreements to contribute cash or property, or contracts for services to be performed. *See*, *e.g.*, FLA. STAT. ANN. § 608.4211 (LEXIS through 2013 Reg. Sess.); RPLLCA § 403(a), *supra* note 5, at 155; RULLCA § 401, 6B U.L.A. 478 (2008); VA. CODE ANN. § 13.1-1027(A) (LEXIS through the 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.). In some jurisdictions, if a member fails to make a required contribution of property or services, the member is obligated to contribute cash equal to the value of the stated contribution that was not made. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.200(3) (LEXIS through 2013 First Extra. Sess.); R.I. GEN. LAWS § 7-16-25(c) (LEXIS through 2013 Reg. Sess.); RPLLCA § 403(b), *supra* note 5, at 155; RULLCA §§ 402, 403, 6B U.L.A. 479 (2008); VA. CODE ANN. § 13.1-1027.B (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.). While the general rule under Code § 721(a) is that neither gain nor loss is recognized upon the contribution of property to a partnership in exchange for an interest in the partnership, attention needs to be paid to Code § 721(b) and

1. Initial Contributions:

Member	Form of Contribution (if debt, how secured)?[43]	Value[44]
1		
2		
3		
4		
5		
6		

2. Representations and warranties regarding debt and title related to contributions (Title insurance required by LLC?) (Consider preparation of separate contribution agreement[45]): _____

_____

_____

_____

Treas. Reg. § 1.351-1(c)(1) to avoid the unintentional recognition of gain upon the contribution of appreciated property to an LLC that is treated as an "investment company." Although LLC acts permit the contribution of services, and the contribution of services is essential for many LLCs, Code § 721 (a) does *not* apply to contributions of services. The tax treatment of service contributions has been very controversial. 26 U.S.C. § 721(a) (2012). However, if the LLC member does not receive any capital account credit for services, the member often can receive an LLC interest for services without triggering immediate income. In this checklist, service contributions are treated separately from capital contributions. For analysis of member contributions, including contribution of services, see BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 5.04[3][b], 5.04[4]; RIBSTEIN & KEATINGE, *supra* note 1, § 5:4.

43. If the LLC is maintaining capital accounts under the Code § 704(b) regulations, an LLC member generally will not get immediate capital account credit for contributing the member's own promissory note. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(d)(2) (as amended in 2013).

44. The stated value of contributed property will generally be whatever amount the parties agree is fair market value, although the parties may adopt other procedures (such as an appraisal or a formula) for setting value. The capital accounting rules of Treas. Reg. § 1.704-1(b)(2)(iv)(b) require capital accounts to be increased by (among other things) the fair market value of contributed property, net of liabilities that the partnership is considered to assume or take subject to.

45. A contribution agreement is a separate agreement that details the assets (and liabilities) that each member contributes to the LLC and should set forth the value of those contributions for purposes of establishing each member's capital account.

D. Additional contributions:

1. Are additional contributions required?[46] ☐ Yes ☐ No

2. If agreed in advance:

	Form of Contribution	Value Amount	Date or Conditions of Making Contribution
1			
2			
3			
4			
5			
6			

3. Are additional capital calls permitted?[47]

☐ Yes
☐ No

a. Triggering events:

(1) Who can make the capital call?
(2) Specific event or circumstance or process?

b. Manager makes call; Members must contribute pro rata

(1) within _____ days/weeks/months, or
(2) within the time period specified in call notice

c. Manager makes call; if _____% of Members consent, Members must contribute pro rata

(1) within _____ days/weeks/months, or
(2) within the time period specified in call notice

d. Voluntary contribution (changes sharing ratio/operating agreement may have pro rata rights?)

46. The responsibility and liability for contributing the equity capital needed by the enterprise are subjects that should receive considerable attention when negotiating and drafting an operating agreement. Members want to limit the amount of capital that they may be required to contribute to a venture. A business, however, likely will fail if it is chronically undercapitalized and is unable to acquire equity capital or other financing when it is needed. The tension between a venture's need for equity capital and the reluctance by some or all of its members either to obligate themselves to contribute capital when it is needed or accept dilution of their economic interests is often difficult to reconcile.

47. Additional issues arise if members are not required to participate in contributions. Members who choose to contribute will probably want their shares of LLC profits to increase relative to the shares of members who fail to contribute. Thus, as in the case of defaults in required capital contributions, drafters should consider including a provision to reduce the interest of non-contributing members in LLC profits. *See* Bradley R. Coppedge, *LLC Operating Agreements Drafting Tips and Traps for the Unwary*, PROB. & PROP., Jan./Feb. 2005, at 44, 50. However, members who may be less able to come up with additional capital should consider the potential for unfair dilution of their interests in profits.

4. Consequences of failure to fund[48]:
    a. Reduction in share of profits
    b. Reduction in share of profits and reallocation of capital
    c. Preferential distributions to other Members
    d. Loan from company at ____%
    e. Loan from non-defaulting Member (and interest rate)
    f. Personal liability on the part of Member
    g. Opportunities for other Members to make up and defaulting Member is diluted
    h. Suspension of management authority or voting rights
    i. Right to purchase defaulting Member's interest in the LLC
    j. Forfeiture of defaulting Member's interest in the LLC
    k. Automatic diversion of distributions to make up deficit (lien like)
5. Adjustment of capital accounts.[49]

48. *See* Terence Floyd Cuff, *Drafting Partnership and LLC Agreements: Part I*, BUS. ENTITIES, May/June 2001, at 22 (discussing various remedies for dealing with defaults in capital contributions and potential tax consequences of provisions that result in capital shifts among venturers). Cuff further notes that the enforceability of default provisions may vary considerably among the states. *See also* Coppedge, *supra* note 47, at 50. Dealing with consequences of a failure to meet a required capital call is a complicated issue. As noted by one commentator, it is sometimes suggested that the non-defaulting participants "want to be able to castrate the defaulting venture, coat him in honey, and bury him in an ant hill in the hot summer sun." *See* Cuff, *supra*, at 22 n.8. That same commentator goes on to note "[t]his particular remedy normally is not permitted under state laws concerning LLCs or partnerships." *Id.* at 22 n.14. For further analysis of remedies for default, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 6.05[1][c]; RIBSTEIN & KEATINGE, *supra* note 1, §§ 5:7, 5:8.

The starkest division between provisions addressing a defaulted capital contribution obligation are between those that mandate a buyout or forfeiture of the interests of the defaulting participant versus those provisions that simply provide for the dilution of that participant's interest. One question to keep in mind in deciding which avenue to take is whether a default will so taint the relationship between the defaulting participants as to make proceeding after dilution appropriate and effective. Note, however, that providing for a buyout of the interests of the defaulting member will require a disposition of company capital and to that extent perhaps constitutes a further negative impact upon the non-defaulting members. If neither a default nor forfeiture is provided for, but rather dilution applies, operating agreements may provide for some or all of (i) a reduction/dilution in the interest of the defaulting venturer; (ii) allowance of the other venturers to make deemed loans to the venture on behalf of the defaulting venturer in the amount of the default giving rise to an obligation of the defaulting venturer to satisfy those loans by the substitution of capital; (iii) the loss of management or voting rights during the pendency of the default; and (iv) a suit for specific performance of the obligation to contribute. While it is not uncommon to see provisions calling for the forfeiture of the interest of the defaulting participant, "one common error is to assume that a court will enforce whatever you draft. The capital contribution default remedy provisions are similar to liquidated damages provisions. A remedy provision will not do you much good if you cannot enforce it. The enforceability of default provisions may vary considerably from state to state or be undermined by a partner in bankruptcy." *See* Cuff, *supra*, at 22 n.8. Some LLC acts expressly state that forfeiture is permitted. *See* DEL. CODE ANN. tit. 6, § 18-502(c) (LEXIS through 2014 Fiscal Sess.); GA. CODE ANN. § 14-11-402(b) (LEXIS through 2014 Reg. Sess.); KY. REV. STAT. ANN. § 275.003(2) (LEXIS through 2013 1st Extra Sess.).

Dilution provisions may have unintended tax consequences in the nature of a capital shift or may alter interests in the LLC in such a manner as to transfer unrealized appreciation, either of which may result in a taxable consequence. *See generally* Terence Floyd Cuff, *Tax Aspects of Partnership Dilution Provisions*, BUS. ENTITIES, Mar./Apr. 1999, at 16; BISHOP & KLEINBERGER, *supra* note 1, ¶ 8.07.

49. The operating agreement may permit or require the capital accounts to be adjusted in some circumstances to reflect a "revaluation" of the LLC's property (including goodwill). Although the

E. Issuance of equity interests to service provider[50]:

1. Will the LLC issue equity interests as compensation for services?[51]

provisions for those adjustments may be buried in the definition of a term such as "Gross Asset Value," or in a "Tax Appendix" to the agreement, they may be crucial to the economic deal. Be careful who is given the authority to decide on the time and amount of those adjustments. For capital accounts that comply with Treas. Reg. § 1.704-1(b)(2)(iv), adjustments generally may be made: (i) in connection with a contribution of money or other property (other than a *de minimis* amount) to the partnership by a new or existing partner as consideration for an interest in the partnership; (ii) in connection with the liquidation of the partnership or a distribution of money or other property (other than a *de minimis* amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership; (iii) in connection with the grant of an interest in the partnership (other than a *de minimis* interest) as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner; or (iv) under generally accepted industry accounting practices, if substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

50. Assuming that the LLC member is treated as a partner for tax purposes, he or she cannot be treated as an LLC employee for tax purposes. Rev. Rul. 69-184, 1969-1 C.B. 256; I.R.S. Gen. Couns. Mem. 34001 (Dec. 23, 1969); I.R.S. Gen. Couns. Mem. 34173 (July 25, 1969). The LLC member who receives compensation for services from the LLC is self-employed and may be subject to self-employment tax. Many LLC members react with shock or disbelief on learning that the IRS refuses to consider them employees of the business for which they render services. LLCs that consider the tax treatment of member-service providers to be a problem have adopted various approaches for avoiding that treatment. One approach has been to structure the service provider's compensation so that it is a "phantom interest," based in some way on equity but not constituting equity.

Even if an LLC is a "disregarded entity" for income tax purposes, it is required to be treated as a separate entity for employment tax (and excise tax) purposes. For wages paid by a disregarded entity before January 1, 2009, the entity could choose to report employment tax separately, or to have its owner report. *See* T.D. 9356, 2007-1 C.B. 39. For a discussion of compensation for services, employee status, and employment taxes in the LLC, see RIBSTEIN & KEATINGE, *supra* note 1, §§ 21.1–.21; BISHOP & KLEINBERGER, *supra* note 1, ¶ 4.10[2].

51. If the conditions of a "safe harbor" are met, the IRS will not impose an immediate tax on a member who receives an interest in LLC profits in exchange for services. *See* Rev. Proc. 93-27, 1993-27 C.B. 343; *see also* Rev. Proc. 2001-43, 2001-2 C.B. 191 (unvested interests). If the safe harbor is not satisfied, the treatment of the service provider may be less clear. If the member receives an interest in the capital of the LLC for past or future services, the member is deemed to have received taxable compensation income. The amount of the compensation income may be difficult to determine but might be deemed equal to the capital account credit given to the service provider. The company generally will have an equal deduction for compensation paid. Proposed regulations and an accompanying notice would, if adopted, revoke Rev. Proc. 93-27 and Rev. Proc. 2001-43, and would cause large changes in current practices. The proposed regulations take the position, however, that the company would not have gain recognition in connection with issuing a capital interest to a service provider. Some advisors are concerned, however, that, in the absence of final regulations, there is some risk that the company granting a capital interest to a service provider might be deemed to have "sold" a portion of its assets to the service provider, possibly triggering a taxable gain to the company.

LLCs issuing, and service providers receiving, LLC equity in connection with the performance of services should consider the advisability of a "Section 83(b)" election. The election is made by the service provider, but because it may affect all members of the LLC, the service provider and LLC will sometimes agree in advance whether the election is to be made. If the service provider is going to make the section 83(b) election, he or she needs to do so within the required thirty-day window.

☐ Yes
☐ No

☐ Vested
☐ Unvested

☐ Profits interest
☐ Capital interest

2. For services by Members?

☐ Yes
☐ No

3. For services by non-Member employees? (If so, consider phantom interests.[52])

☐ Yes
☐ No

F. Member guarantees of LLC obligations[53]:

1. ☐ No
2. ☐ Partial: _____

_____

_____

3. ☐ Unlimited: _____

_____

_____

4. ☐ Agreement to participate in guarantees of future LLC obligations
5. ☐ Contribution rights for joint guarantees

52. *See infra* note 63.

53. Absent an extraordinary waiver of limited liability (*see*, *e.g.*, KY. REV. STAT. ANN. § 275.150(2) (LEXIS through 2013 1st Extra Sess.); RULLCA § 110(g), 6B U.L.A. 442 (2008); TEX. BUS. ORGS. CODE ANN. § 101.114 (LEXIS through 2013 3d Called Sess.)), members, as members, are not personally liable for the debts and obligations of the LLC. As a condition to extending credit, certain creditors will insist upon personal guaranties from some or all of the members. Circumstances may justify providing in the operating agreement some combination of (a) a commitment by each member to guarantee some or all obligations of the LLC, (b) an undertaking, in particular circumstances, to execute and deliver a personal guaranty, and/or (c) a power of attorney authorizing an agent to bind the member to guarantee an LLC obligation. *See generally* BISHOP & KLEINBERGER, *supra* note 1, ¶ 6.04[1] (discussing personal guaranties of members as well as practice pointers for the unwary).

When personal guaranties are given, the operating agreement should address contribution obligations among the members when less than all guarantors satisfy the obligation and the determination of each member's contribution amount. In addition, members should consider the interaction of any buy-sell provisions with personal guaranties. In the event a member's interest is being purchased by another member or redeemed by the LLC, the release of the departing member's personal guaranty or an agreement of the purchasing member to indemnify the departing member should be considered. Guaranties and contribution obligations can have important tax consequences. *See supra* note 18.

G. Distributions:

1. General questions about distribution scheme:

   a. Will distributions be made in proportion to capital contributed?[54]
   b. Will any Members receive a preferential return on capital?[55]
   c. Will any Members receive a preferential return of capital?[56]
   d. Are preferences intended to be temporary or permanent?[57]
   e. Will operating distributions and capital distributions be treated differently?

2. Guaranteed payments[58]:_____.

3. Distributions of proceeds from operations:

   a. Define operations.
   b. Sharing ratios and economic units[59]

54. There are many reasons why distributions may not be in proportion to capital contributed, but perhaps the most common reason is that some distributions reflect the provision of services by some of the members.

55. For example, in an LLC in which one member ("Capital Partner") contributes $1,000, and the other member ("Service Partner") contributes only services, Capital Partner may be entitled to a distribution equal to 10 percent simple interest annually, cumulatively on unreturned capital, before Service Partner receives any distribution.

56. A preferential return of capital to the Capital Partner is one sign that the Service Partner is likely to be allocated "phantom income" and may want to demand a "tax distribution" in order to have enough cash to pay its tax liability. *See infra* note 66.

57. For example, if Capital Partners get a 10 percent interest-like preference, and the residual profits are split 80 percent Capital Partners/20 percent Service Partners, will the Service Partners get to "catch up" so that they receive 20 percent of all profits, including the 10 percent that went to the Capital Partners (which would mean that the 10 percent was a temporary preference for the Capital Partners)? Or instead will the Service Partners share in whatever profits are left over after the Capital Partners receive their 10 percent (which would make the 10 percent a permanent preference for the Capital Partners)?

58. A "guaranteed payment" under Code § 707(c) is not "guaranteed" in any normal sense. 26 U.S.C. § 707(c) (2012). Rather, it is a payment to a partner for services or the use of capital, determined without regard to the income of the partnership. There may be important tax differences between an allocation and distribution, on the one hand, and a guaranteed payment on the other. For some purposes, but not all, a guaranteed payment is treated as paid to a third party. Fixed salary-type payments to a Service Partner are normally treated as guaranteed payments, regardless of whether they are provided for in a separate "employment agreement" apart from the LLC's operating agreement. Preferences to Capital Partners sometimes constitute guaranteed payments. Guaranteed payments for capital often resemble interest payments, but the tax consequences may be different. A payment made to a partner "other than in his capacity as a member of such partnership"—such as a loan—is not a "guaranteed payment" but is treated as occurring between the partnership and a third party. *See generally* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS ¶¶ 14.02–.03 (4th ed. 2007) [hereinafter MCKEE]. Many operating agreements are careful to observe a distinction between distributions and payments.

59. The general rule in corporate law is that all shares of stock of the same class "must have preferences, limitations, and relative rights identical with those of other shares of the same class." *See*, *e.g.*, GA. CODE ANN. § 14-2-601 (LEXIS through 2014 Reg. Sess.). There is no such rule in LLC law, even if the operating agreement uses corporate jargon by designating interests in the LLC as "shares," "classes," or the like. An LLC "unit" is essentially whatever the operating agreement says it is. Do not be fooled by terminology such as "unit" into assuming that all the "units," or all the "units" of a given "class," are fungible, or that all important aspects of the members' rights and obligations are captured in the terms of the "units." Instead, LLC interests "may, and frequently do, on a per-unit or per-share basis, have different interests in the management, capital, profits, losses, and tax attributes of the LLC. A common mistake is to forget to take those differences into account when drafting the buy-sell, pre-

Member	Sharing Ratio	Economic Units
1		
2		
3		
4		
5		
6		

c. ☐ In accordance with capital accounts

d. ☐ Any preferred return on capital contributions (temporary or permanent)? _____

_____

e. ☐ Any preferred return of capital contributions? _____

_____

f. ☐ Draws or advances[60]: _____

_____

g. ☐ Other: _____

_____

_____

4. Distribution of proceeds from capital transactions.

a. Define capital transactions:

(1) ☐ Sales of capital assets
(2) ☐ Refinance
(3) ☐ Other

b. ☐ In accordance with capital accounts
c. ☐ As preferred return on capital contributions
d. ☐ In accordance with sharing ratios
e. ☐ In accordance with economic units

emptive rights, co-sale rights, drag-along rights, put and call options, liquidating distribution, etc. provisions of the operating agreement." Warren P. Kean, *Common Mistakes and Oversights When Drafting and Reviewing LLC Operating Agreements*, PUBOGRAM, Mar. 2008, at 6; Andy Immerman, *Is There Any Such Thing as an LLC Unit?*, BUS. ENTITIES, July/Aug. 2009, at 20.

60. Strictly speaking, an advance or draw is somewhat different from a distribution, and the difference may have important tax consequences. An advance or draw against a partner's distributive share of income is treated as a current distribution made on the last day of the partnership taxable year. Treas. Reg. § 1.731-1(a)(1)(ii) (1960); *see generally* MCKEE, *supra* note 58, ¶ 19.03[2].

f. ☐ Other: _____

_____

_____

5. Liquidating distributions after state law creditors[61]:

a. ☐ In accordance with capital accounts
b. ☐ As preferred return on capital contributions
c. ☐ In accordance with sharing ratios
d. ☐ In accordance with economic units
e. ☐ As preferred return on capital contributions
f. ☐ Other: (Should it mirror distribution provisions? Not see problem if mirrors economic relationships.) _____

_____

_____

6. Distributions in kind[62]:

☐ Prohibited (all distributions must be in cash)
☐ Permitted if pro rata among Members

61. Many LLCs provide for distributing liquidation proceeds in accordance with positive capital accounts because that provision may help ensure that the LLC's allocations are respected for tax purposes. However, many LLCs, especially those formed in recent years, do not provide for liquidating distributions in accordance with capital accounts. In particular, LLCs using "targeted allocations" (also known as "forced allocations") do not provide for liquidating distributions in accordance with capital accounts. *See* Terence Lloyd Cuff, *Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements*, 65 N.Y.U. TAX LAW INST. § 18.07[5] (2009).

Most LLC acts are similar to each other in their provisions for disposing of assets upon liquidation. Assets must first be applied to discharge obligations to creditors. Whether or not payments to creditors on liquidation technically should be called "distributions," many operating agreements treat them as distributions. The default rule of RULLCA directs that surplus be used to return all contributions not previously returned and that the remainder be distributed to the members in equal shares. RULLCA § 708(b), 6B U.L.A. 514 (2008); *see also* RPLLCA § 711(b), *supra* note 5, at 181. The default rule under the Kentucky LLC Act provides for distribution of LLC assets upon liquidation as follows: (1) to creditors; (2) to members or former members in satisfaction of liabilities for declared but unpaid distributions; and (3) "to members and former members first for the return of their contributions and second in proportion to the members' respective rights to share in distributions from the LLC prior to dissolution." KY. REV. STAT. ANN. § 275.310 (LEXIS through 2013 1st Extra Sess.). The operating agreement generally will not affect the rights of third-party creditors, but it can establish how distributions to members will be dealt with upon liquidation, and will generally supersede the LLC act's provisions regarding distributions to members.

62. Certain LLC acts, absent a contrary provision in the operating agreement, preclude distributions in kind (*e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 4A-504 (LEXIS Emergency Leg. through 2013 Second Reg. Sess.); NEV. REV. STAT. § 86.346 (LEXIS through 2013 Reg. and Special Sess.)) or permit distributions in kind only to the extent the assets are distributed pro rata among the members (*e.g.*, KY. REV. STAT. ANN. § 275.220(2) (LEXIS through 2013 1st Extra Sess.); TEX. BUS. ORGS. CODE ANN. § 101.203 (LEXIS through 2013 3d Called Sess.)). Prohibiting distributions in kind limits flexibility and may compel the sale of an asset in a falling or illiquid market or otherwise in a "fire sale." Conversely, distributing an asset in common tenancy among the members following a dissolution may compel former members who did not want to be in business with one another to continue in that role, although now outside of an LLC. In addition, holding property as tenants in common may

☐ Other: _____

_____

_____

7. Tax distributions[63]:

☐ Yes
☐ No

sometimes give rise to a deemed partnership for tax or non-tax purposes. In recent years, the borderline between tenants in common and deemed partners has been explored intensively in connection with tax-free exchanges. *See generally* Rev. Proc. 2002-22, 2002-1 C.B. 733. Some situations may justify permitting non-pro-rata in kind distributions subject to appropriate oversight of valuation.

63. Operating agreements may provide for so-called "tax distributions." Income of a partnership is taxed to the partners when it is earned by the partnership, whether or not it is distributed. Income that is allocated, without any corresponding distribution, is sometimes called "phantom income." The point of a tax distribution is to minimize the risk that partners will have to pay tax on allocated income when they have not received enough cash to pay the tax. Tax distributions should not be looked on as a special kind of distribution. It is more accurate to think of them as advance distributions of amounts that, at least at the time the distributions are made, the partner appears to be entitled to receive eventually. Because it is usually impractical to determine the actual amount of cash that a member needs to pay taxes, tax distributions are usually made under certain general assumptions about tax rates. Members who receive an interest in LLC profits in connection with performing services tend to have a particularly acute need for tax distributions. Some advisors mistakenly attempt to eliminate the need for tax distributions by providing that income will be allocated away from the members who are not otherwise receiving distributions. These attempts may result in invalid allocations or distortions in the economic deal. A sample tax distribution provision is set out in Coppedge, *supra* note 47, at 48. U.S. corporate and individual taxpayers must pay estimated taxes under Code Sections 6654 and 6655. An operating agreement often provides that tax distributions are to be made by the LLC in time for the equity owners to use the distributed funds to pay, or help to pay, their estimated tax liabilities. Although those payments are frequently referred to as having to be made on a quarterly basis, the payment dates do not fall precisely three months apart from each other.

The general rule is that 25 percent of the "required annual payment" (which, with certain exceptions, is between 90 percent and 100 percent of the total tax actually due by the taxpayer for the taxable year) must be paid with each installment. Both corporations and individuals, however, may determine the amount of estimated taxes to pay with each installment on an annualized basis. The definition of "Net Taxable Income" used in determining the LLC's "Net Taxable Profits" applies such an annualized approach to determine the LLC's quarterly taxable income.

The federal government is only one of the taxing authorities to which an equity owner may be required to pay income taxes on the equity owner's share of the LLC's income. Moreover, in addition to regular federal income taxes, an equity owner may be subject to other federal taxes, such as excise taxes, withholding taxes, alternative minimum taxes, and self-employment taxes. The non-managing members may want to include language in the operating agreement to help bolster their position that they should be treated as "limited partners," who under Code § 1402(a)(13) are not subject to self-employment taxes (i.e., SECA taxes) on their distributive share of a partnership's net trade or business income. See RIBSTEIN & KEATINGE, *supra* note 1, §§ 21.01–.21 for additional discussion on the federal tax treatment of employees and other service providers of LLCs. *See also* BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 4.10, 4.13[3][c].

In addition, different types of income may be subject to different rates of tax (most notably, long-term capital gains are taxed to individuals at preferential rates). Furthermore, federal and state tax credits may flow through the LLC. Accordingly, the parties can, at best, approximate what they believe to be a fair rate for computing the tax distributions to be made, while attempting to minimize both the amount of cash an equity owner will have to use from other sources to pay taxes owed on undistributed earnings and the amount of cash flow redirected for tax distributions. For that reason, an agreement may impute a rate of tax that can be adjusted from time to time as the manager-members deem appropriate (such as, by factoring in the capital gains rate if the LLC has a significant

a. ☐ automatically at ____% of taxable income
b. ☐ automatically at % redetermined periodically by Members or Managers
c. ☐ automatically at highest combined marginal state and federal rate for an individual in specified state, taking into account the federal deduction of state taxes
d. ☐ take into account different rates on different types of income
e. ☐ take into account different rates paid by different Members
f. ☐ tax distributions to all Members, pro rata by profit share
g. ☐ tax distributions only to Members who would otherwise have phantom income
h. ☐ Member applies to Manager; Manager approves
i. ☐ Member applies to Manager; Manager approves; Members' approval required at ____%
j. ☐ Member applies to Manager; Manager approves; if Manager declines, special meeting of Members is called (or consent required) who have to approve at _____%

H. Maintenance of capital accounts. Capital accounts will be maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv)[64]: ☐ Yes ☐ No

1. "Tax Basis";
2. "Tax Book Rules";
3. GAAP;

amount of long-term capital gains for a taxable year or quarter or having those equity owners taxed at higher rates agree to a lower imputed rate).

Another formulation is to provide that the rate shall be "the highest combined federal, state and local and, in some cases, foreign marginal income tax rate (adjusted for any deductions or credits allowed by one taxing authority for taxes paid to another taxing authority) applicable with respect to the Interest of any Equity Owner as reasonably determined by the Manager and/or Members at the time that the income in respect of which those distributions are to be made was earned by the Company." As pointed out above, this formulation is really no more precise than using a fixed, stipulated rate but will require the LLC to spend significantly more time and effort to derive it year after year—an exercise that many conclude is unnecessary and needlessly burdensome. An in-depth review of tax liability distribution appears in *Model Real Estate Development Operating Agreement*, 63 Bus. Law. 385, 452–54 (2008).

64. These four alternatives are the ones listed on IRS Schedule K-1. It is usually advisable, and sometimes essential, for an LLC to maintain capital accounts in accordance with the principles of Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 2013), whether or not the LLC also needs to maintain additional capital accounts under other principles. Under Treas. Reg. § 1.704-1(b)(2)(iv), each partner has one and only one capital account; capital accounts are kept for each partner and not for each "unit" (or "share"). For purposes of the capital account rules, the division of LLC interests into "units" (or "shares") is generally ignored by the IRS. Although the tax rules tend to have an enormous influence on capital account maintenance, capital accounts can be—and often are—fundamental to the economics of the deal. Do not assume that everyone except the tax advisors can safely ignore capital accounts.

4. Optional/Additional method: _____

_____

I. Allocations of profits and losses[65]:

1. "704(b)" safe harbor[66]

   a. ☐ "Deficit Restoration Obligation"
   b. ☐ "Alternate" test

2. Targeted capital accounts[67]

3. Other: _____

_____

_____

_____

J. Allocation of debt (if any).[68]

65. Allocations are among the most confusing topics in partnership tax. A tax expert may be required, even for many apparently simple transactions. One problem is that allocations, unlike most aspects of the LLC, leave very limited room for negotiation and agreement among the parties. Valid allocations are less flexible than parties sometimes assume. In a typical business deal, allocations will be dictated by the flow of contributions in and distributions out of the LLC. The existence of alternative drafting techniques should not disguise the very limited nature of the parties' freedom to allocate. Over the entire life of the LLC, contributions plus allocations of income (minus allocations of deductions) ought to equal distributions. If you know how you want contributions to be made, and how you want distributions (importantly including liquidating distributions) to be made, then the allocations tend to follow. An important exception exists for allocations attributable to nonrecourse debt. For distinction between allocations and distributions, see ROBERT L. WHITMIRE ET AL., STRUCTURING AND DRAFTING PARTNERSHIP AGREEMENTS ¶ 4.01[1] (3d ed. 2003) [hereinafter WHITMIRE DRAFTING].

LLC acts may have default provisions on the allocation of profits and losses. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.205 (LEXIS through 2013 1st Extra Sess.) (profits and losses of an LLC "shall be allocated on the basis of the agreed value, as stated in the records of the [LLC] as required by KRS 275.285, of the contributions made by each member to the extent they have been received by the [LLC] and have not been returned"); *see also* TEX. BUS. ORGS. CODE ANN. § 101.201 (LEXIS through 2013 3d Called Sess.). The Revised Prototype Act provides for per capita (i.e., equal among the members) distributions. *See* RPLLCA § 404(a)(1), *supra* note 5, at 156. However, allocation provisions for operating agreements are normally drafted primarily with tax considerations in mind and with little regard for the LLC act defaults. If special allocations are desired, provisions authorizing specialized allocations should be added. *See generally* MCKEE, *supra* note 58, ¶¶ 11.01–.08; BISHOP & KLEINBERGER, *supra* note 1, ¶ 4.12.

66. *See generally* MCKEE, *supra* note 58, ¶ 11.02. It is virtually unheard of for LLC members to agree to an unlimited deficit restoration obligation. If the LLC wants to comply with the "safe harbor," it will rely on the "alternate test."

67. On "targeted capital accounts" (or "forced allocations"), see Terence Floyd Cuff, *Working with Target Allocation—Drafting in Wonderland*, REAL EST. TAX'N, 3Q 2008, at 162; Terence Floyd Cuff, *Working with Target Allocations—Idiot-Proof or Drafting for Idiots?*, REAL EST. TAX'N, 2Q 2008, at 116. Regarding forms of targeted allocation provisions, see, for example, WHITMIRE DRAFTING, *supra* note 65, ¶ 5.05[2] (forced allocation technique); Cavanaugh, *Targeted Allocations Hit the Spot*, TAX NOTES, Oct. 4, 2010, at 89.

68. Debt incurred by the LLC, both recourse debt and nonrecourse debt, is included in the tax bases that the members have in their LLC interests. The rules for allocating debt among the partners are quite elaborate and vary depending on whether the debt is recourse or nonrecourse. *See* 26 U.S.C.

K. Code § 704(c) methodology and reverse § 704(c) methodology[69]:

- ☐ Traditional
- ☐ Traditional with curative
- ☐ Remedial
- ☐ Other:_____

_____

_____

L. Loans from Members[70]:

1. May Members make loans to the LLC?
   - ☐ Yes. If Yes, who makes that determination?_____

     _____
   - ☐ No
2. Are Members obligated to make loans to the LLC?
   - ☐ Yes
   - ☐ No

§ 752 (2012); Treas. Reg. §§ 1.752-1 through -7 (as amended in 2006); *see generally* MCKEE, *supra* note 58, ¶¶ 8.02–.03. The definition of "nonrecourse" debt for those purposes may surprise business lawyers. A liability is nonrecourse "to the extent that no partner or related person bears the economic risk of loss for that liability." Treas. Reg. § 1.752-1(a)(2). Thus, debt that is fully recourse to all the assets of the LLC may be "nonrecourse" under the tax rules.

69. Code § 704(c) deals with the tax consequences of contributed property that, at the time of contribution, has a value either higher or lower than its tax basis and is mandatory. 26 U.S.C. § 704(c) (2012). The choice of Code § 704(c) method(s) set forth in the checklist can make a big difference. For example, if the contributed property is sold at its tax basis, but at a loss from book value, the owner would have no taxable gain under the traditional method(s) but could have substantial taxable gain under the remedial method. If the property is depreciable or amortizable, the selection of Code § 704(c) method becomes more significant because it may affect the amount of taxable income or loss for each equity owner during the applicable recovery period. Members often will negotiate which Code § 704(c) allocation method to use with respect to particular property contributed to the LLC. The members usually will have adverse interests on this issue, and any method likely will benefit some members at the expense of other members. Because of the adverse interests of the members, the LLC should not leave the choice of Code § 704(c) to the manager unless it is intended that the manager have the authority to favor some members at the expense of others. The choice of Code § 704(c) method(s) can have significant tax and, therefore, economic consequences to the parties. Thus, those provisions relating to the selection of the Code § 704(c) method(s) to be adopted by the LLC should not be treated as insignificant or neutral boilerplate. Different methods may be used for different assets. "Reverse 704(c)" allocations deal with the situation in which a partnership revalues its assets in connection with a distribution or contribution, and the new value of an asset differs from the tax basis of the asset. *See* Cuff, *supra* note 67, § 18.83.

70. The mechanism for approving a member loan is addressed below in Part V.

3. If mandatory:
   a. Amount: $_____
   b. Interest Rate: _____
   c. Term: _____
   d. ☐ Collateral: _____
      ☐ Not collateralized
   e. Remedies upon default: _____
      _____
      _____

4. If permitted:
   a. Amount: $_____
   b. Interest Rate: _____
   c. Term: _____
   d. Description of collateral: _____
      _____
      _____
   e. Remedies upon default: _____
      _____
      _____
   f. Recourse or Nonrecourse:
      ☐ Recourse ☐ Nonrecourse

M. Transfers of membership interests[71]:

71. Membership in an LLC typically carries with it financial rights (especially the right to distributions) and non-financial rights (such as the right to vote, participate in management, or receive information). In Delaware and Georgia, LLC "interest" essentially means "economic interest," so in some states it could be confusing to refer to "full membership interest." Generally, the operating agreement restricts transfer of LLC interests to reflect the intent of the parties to be able to veto new members. There is no uniform anti-transfer provision, and thus any such provision must be specifically tailored to the transaction. Transfer of only the financial interest in an LLC is permitted by each LLC act since it does not affect the management of the LLC. *See generally* RIBSTEIN & KEATINGE, *supra* note 1, § 7:3; BISHOP & KLEINBERGER, *supra* note 1, ¶ 8.06. Under most state LLC acts, the transfer of an interest merely transfers the member's right to receive distributions (the economic interest), and the assignee does not have an automatic right to become a member or to participate in the management of the LLC. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.255(b)–(c) (LEXIS through 2013 1st Extra Sess.); RPLLCA § 502(a)(4)(A)–(B), *supra* note 5, at 163; RULLCA § 502(a)(3), 6B U.L.A. 496 (2008); TEX. BUS. ORGS. CODE ANN. § 101.109 (LEXIS through 2013 3d Called Sess.).

1. Voluntary transfers:

   a. ☐ Absolutely prohibited[72]
   b. ☐ Permitted, but assignee is not admitted as a Member without consent of ____% of the other Members[73]
   c. ☐ Permitted only with consent of ____% of the other Members
   d. ☐ Permitted to:

      (1) ☐ Spouse[74]
      (2) ☐ Children
      (3) ☐ Other relatives:_____

      _____

      _____

      _____

      (4) ☐ Trusts for any of the above
      (5) ☐ Controlled business entities but only under these conditions[75]:

         ☐ Assignee automatically becomes Member
         ☐ Assignee is not admitted without consent
         ☐ Permitted only with consent of _____% of the other Members

72. Consider whether applicable state law will enforce an absolute prohibition on transfer. *See generally* HOWARD M. ZARITSKY ET AL., STRUCTURING BUY-SELL AGREEMENTS: ANALYSIS WITH FORMS ¶ 7.03 (2014); *see also* EGON GUTTMAN, MODERN SECURITIES TRANSFERS § 7:7 (4th ed. 2013).

73. This approach is often adopted by states as the default rule. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.265(1) (LEXIS through 2013 1st Extra Sess.) ("[A]n assignee of a limited liability company interest shall become a member only if a majority-in-interest of the members consent."); MD. CODE ANN., CORPS. & ASS'NS § 4A-604 (LEXIS Emergency Leg. through 2013 2d Reg. Sess.) (all members must consent to an assignee being admitted, unless the operating agreement provides otherwise); TEX. BUS. ORGS. CODE ANN. § 101.109(b) (LEXIS through 2013 3d Called Sess.) ("An assignee of a membership interest in a limited liability company is entitled to become a member of the company on the approval of all of the company's members.").

74. It may be desirable to provide an absolute right to transfer to or for the benefit of (i.e., trust) permitted transferees (such as the member, a spouse, or children), which would permit transfer to those persons without triggering right of first refusal provisions. Coppedge, *supra* note 47, at 47. This sort of provision could also be made applicable only in the event of death or other involuntary transfer. Consider whether the provision for permissible transfers should (or should not) provide that the transferee will be admitted automatically as a substitute member. "The primary drawback to this option is that the other members may end up with partners not of their choosing." *Id.* For tax discussion relating to sales and transfers of economic rights to the LLC and to persons other than the LLC, see BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 8.07[1], 8.07[2]; RIBSTEIN & KEATINGE, *supra* note 1, §§ 20.01–.39.

75. Some operating agreements allow the transfer of membership interests to an entity controlled by the transferring member. Those provisions create the potential for abuse if inadequately drafted, allowing the member to transfer her interest to a single-member LLC that she controls, then selling that interest to an unrelated third party. To prevent this type of situation, provisions should dictate the buy-out of the indirectly transferred member interest if the agreement provides that a change of control is deemed a transfer. *See generally* Terence F. Cuff, *Drafting Partnership and LLC Agreements: Part II*, BUS. ENTITIES, July/Aug. 2001, at 26; Cuff, *supra* note 67, § 18.40.

2. Involuntary transfers.

   a. ☐ Assignee is not admitted without consent of all other Members[76]

   b. ☐ Assignee not admitted without consent of _____% of the other Members

3. ☐ Right of first refusal[77]
   ☐ Right of first offer

   a. ☐ Voluntary transfers:

      (1) ☐ Exercisable by LLC
      (2) ☐ Exercisable by Members but not Economic Interest Holders
      (3) ☐ Exercisable by Members and Economic Interest Holders
      (4) ☐ Exercisable by LLC first and Members second
      (5) ☐ Exercisable by LLC first and Members and Economic Interest Holders second

   b. ☐ Involuntary transfers:

      (1) ☐ Exercisable by LLC
      (2) ☐ Exercisable by Members but not Economic Interest Holders
      (3) ☐ Exercisable by Members and Economic Interest Holders
      (4) ☐ Exercisable by LLC first and Members second
      (5) ☐ Exercisable by LLC first and Members and Economic Interest Holders second

N. Disengagement arrangements[78]:

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76. Under section 541(c) of the Bankruptcy Code, a debtor's bankruptcy estate automatically succeeds to the debtor's property, which includes a member's financial rights and may include some governance rights. Be aware that the trustee in bankruptcy of a member may assert the right to become a substitute member authorized to exercise all rights, including the right to participate in management, of a member, notwithstanding the absence of the consent of the remaining members to the admission of the trustee as a member. *See*, *e.g.*, *In re* Ehmann, 319 B.R. 200, 206 (Bankr. D. Ariz. 2005); *In re* Ehmann, 334 B.R. 437, *withdrawn by* 337 B.R. 228 (Bankr. D. Ariz. 2006); *see also* Thomas E. Rutledge & Thomas Earl Geu, In re Ehmann *II*—*Now You See It, Now You Don't*, BUS. ENTITIES, May/June 2006, at 44. An Ohio court afforded to the estate of a former member the right to participate in the management of the LLC. *See* Holdeman v. Epperson, 857 N.E.2d 583 (Ohio 2006); *see also* BISHOP & KLEINBERGER, *supra* note 1, ¶ 1.04[3][c]; RIBSTEIN & KEATINGE, *supra* note 1, § 7:9.

77. If the operating agreement provides for a right of first refusal, a member who intends to sell his membership interest in the LLC and has negotiated a sale agreement must first offer the LLC or the remaining members an option to purchase that member's LLC interest generally on the same terms and conditions as offered by the potential purchaser. *See* Coppedge, *supra* note 47, at 46. The operating agreement must set forth every step of procedure, with clear time periods from notice through closing. The operating agreement should also spell out exactly what happens if the members fail to exercise the right of first refusal. *See* Terence F. Cuff, *Drafting Partnership and LLC Agreements: Part II*, BUS. ENTITIES, July/Aug. 2001, at 26. Upon the bankruptcy of a member, a right of first refusal that is triggered by bankruptcy or the appointment of a receiver may be treated differently from rights triggered upon any transfer by the member. *See*, *e.g.*, *In re* Capital Acquisitions & Mgmt. Corp., 341 B.R. 632, 638 (Bankr. N.D. Ill. 2006).

78. One means of avoiding deadlock is for the operating agreement to provide economically acceptable exit provisions for members. Any exit provision should require the departing member's

1. Type of arrangement:

   a. ☐ Put[79]
   b. ☐ Call
   c. ☐ Buy-Sell[80] (also called a Russian Roulette, High-Noon, or Shotgun Provision)
   d. ☐ Other[81]: _____

2. Circumstances for exercise of disengagement:

   a. ☐ Any time
   b. ☐ Any time after: _____
   c. ☐ In the event of deadlock
   d. ☐ In the event of certain deadlocks: _____

      _____

      _____

      _____

   e. ☐ Upon the dissociation of Member
   f. ☐ If non-reciprocal rights among Members or classes of Members, describe rights of each here: _____

      _____

      _____

3. Price[82]:

interest to be completely separated from the LLC. *See* RIBSTEIN & KEATINGE, *supra* note 1, § 11:9; *see also* BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 8.02, 8.06.

79. "The put provision provides that a member may, at any time, 'put' his interest to the other members. In this instance, the selling member would notify the remaining members that he or she wishes to buy or sell at a given price." Coppedge, *supra* note 47, at 46. The remaining members have two options: (1) they may sell their interests to the selling member at his stated price or (2) they may purchase the selling member's interest. *Id.*

80. One common form of buy-sell provision generally provides that either member may offer to buy out the other member's LLC interest during a deadlock. Once a member receives such an offer, that member can sell his or her membership interest for the offered price, or buy the offering member's interest for such price (or for a price determined on the same basis if the ownership of the members is not equal).

81. Examples of other exit strategies include a "drag-along" right, which permits a member selling his interest to a third party to force the other members to sell their interests to the same party on similar terms, as well as the "tag-along" right, which permits the other members to require a selling member to require the purchaser of his interest to buy the interest of the other members on similar terms. The possibilities for these types of provisions are limited only by the creativity of the drafter. *See* Terence F. Cuff, *Drafting Partnership and LLC Agreements: Part II*, BUS. ENTITIES, July/Aug. 2001, at 26.

82. It is important to specify how the LLC will be valued upon disengagement of a member. The enterprise may be valued according to a price established by the selling member, determined through an appraisal, or decided by an arbitrator. The mechanism for setting the price on disengagement may tie into the mechanism for booking up capital accounts. *See generally* BISHOP & KLEINBERGER, *supra* note 1, ¶ 8.05; RIBSTEIN & KEATINGE, *supra* note 1, § 11:3.

a. ☐ Set by agreement by Members or Managers on a regular basis[83]

b. ☐ "Book" value[84]

(1) ☐ As kept for tax purposes (prepared by Company's regularly employed accountant)

(2) ☐ "Booked up" to fair market value of Company assets

c. ☐ "Fair Market"[85] determined by appraisal periodically or at time of call, etc.[86]

(1) ☐ As kept for tax purposes

(2) ☐ "Booked up" to fair market value of Company assets.

d. ☐ Formula[87]

O. Dissociation[88]:

83. One approach is to specify that each year the members will determine an agreed value for a 1 percent interest. *See* Coppedge, *supra* note 47, at 46, 47. When the agreement calls for a periodic revaluation by the members, consideration should be given to whether the last agreed value should apply regardless of how "stale," or whether the last agreed value will be non-binding after some period of time and an alternative valuation procedure will instead be employed.

84. As is addressed in the various options identified below with respect to "book value," exactly what in any particular instance will be "book value" both is and properly should be a matter of discussion. For example, in a business that holds property, such as real estate, that is expected to significantly appreciate in value, determining "book value" based upon historical acquisition costs may yield a windfall to those persons who are not being bought out. Similarly, companies in which capital is not a material income-producing item, such as in professional practices, but which do generate significant goodwill, and especially in the case of goodwill that may be traceable to the efforts of one particular owner, there is again the risk that a buyout based upon historical balance sheet values may generate an inappropriate windfall. *See* Estate of Cohen v. Booth Computers, 22 A.3d 991, 1005–06 (N.J. Super. Ct. App. Div. 2011) (disparity in price between book value and fair market value does not make a buyout provision unconscionable if the provision clearly specifies book value).

85. Consider and select between "fair value" and "fair market value," appreciating that courts at times improperly construe the terms as equivalent, *see*, *e.g.*, Ford v. Courier-Journal Printing Co., 639 S.W.2d 553, 556 (Ky. Ct. App. 1982), *overruled by* Shawnee Telecom v. Brown, 360 S.W.3d 152 (Ky. 2011), and as necessary specify whether and how discounts for marketability and/or control should be applied. *See also* Denike v. Cupo, 926 A.2d 869, 883–84 (N.J. Super. Ct. App. Div. 2007) (discussing distinction between "fair value" and "fair market value.").

86. If the appraisal option is selected, the operating agreement should address how an appraiser is to be selected. There are many options for selecting an appraiser—providing a time period for the parties to agree on an appraiser, naming an arbitration service or judge to select an appraiser, or selecting multiple appraisers and averaging the appraisals. Appraisals can be expensive.

87. Formulas may be based on a capitalization of the income stream of the LLC in an effort to obtain an estimate of fair market value or, in the case of a repurchase from a terminated employee, be based on a formula that is not intended to estimate fair market value. The formula could be a percentage of fair market value or be tied to a percentage of the capital account for the interest, but there is an endless variety of possible formulas. If the purchase price is less than the withdrawing member's capital account, the excess capital account will be allocated to the other members, likely triggering taxable income.

88. Of particular importance in those situations is how to handle the removal of the managing member of the LLC. The operating agreement should specify who may remove the manager and under what circumstances. A detailed list of events of default is typical. Also, the operating agreement should set forth provisions for selecting a new managing member. Certain states provide a statutory default rule for the removal of the manager. *See*, *e.g.*, VA. CODE ANN. 13.1-1024(F) (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.).

1. Voluntary withdrawal of a Member[89]:
   a. ☐ Member may not unilaterally withdraw[90]
      (1) Member's interest is repurchased
      (2) Member becomes an assignee
   b. ☐ Member may withdraw upon the consent of:
      (1) ☐ Managers
         (a) ☐ All
         (b) ☐ Supermajority
         (c) ☐ Majority
      (2) ☐ Members
         (a) ☐ All
         (b) ☐ Supermajority
         (c) ☐ Majority

      Upon an approved withdrawal:
      (3) Member's interest is repurchased
      (4) Member becomes an assignee
2. Death, disability, dissolution or bankruptcy of Member[91]:
   a. ☐ Member's legal representative or heir becomes Member without further action
   b. ☐ Member's legal representative or heir continues as an assignee
   c. ☐ Member's interest is repurchased from the legal representative or heir

89. State LLC acts vary with regard to a member's power to withdraw voluntarily from an LLC and receive the financial value of his/her interest. This disparity results from the competing interests between providing some liquidity for LLC members while still protecting the LLC and the remaining members from the disruption caused by dissociation. *See generally* RIBSTEIN & KEATINGE, *supra* note 1, § 11:2; BISHOP & KLEINBERGER, *supra* note 1, ¶ 8.03[1]. Some LLC statutes provide for some type of payment to a withdrawing member under various state-specific formulations. *See* RIBSTEIN & KEATINGE, *supra* note 1, § 11:3; BISHOP & KLEINBERGER, *supra* note 1, ¶ 8.05; *see also* Thomas E. Rutledge, *You Just Resigned—Now What? Different Paradigms for Withdrawing from a Venture*, J. PASSTHROUGH ENTITIES, Nov./Dec. 2009, at 43.

90. It is important to identify a specific dispute resolution mechanism in the operating agreement. In some cases litigation may be appropriate, but other situations may lend themselves best to resolution through arbitration. A mediation requirement may be used as a first step before either binding arbitration or litigation is entered into. Any specific dispute resolution provisions must take into account local law. When drafting an agreement to arbitrate, it is important to define the parties bound by the arbitration, whether the LLC is bound by the obligation to arbitrate, whether it is the exclusive remedy available and whether it is binding, how the arbitrator is selected, and the extent of the arbitrator's authority.

91. Upon the death of a member, only the member's interest in the LLC, and not specific LLC property, passes to the member's estate. The transfer represents the member's financial interest in the LLC and does not include any interest in management. *See* RIBSTEIN & KEATINGE, *supra* note 1, § 7:9; *see also* BISHOP & KLEINBERGER, *supra* note 1, ¶ 8.03[3]. *But see* Holdeman v. Epperson, 857 N.E.2d 583, 588 (Ohio 2006) (executor of estate of deceased member of LLC has all rights that member had prior to death but only for limited purpose of settling estate and administering property).

d. ☐ Member's legal representative or heir becomes Member only with consent

e. Definition of disability:

(1) Guardian/conservator appointed by court
(2) Primary care physician or designee determines inability to manage business affairs
(3) Member has not performed business functions for ___ days
(4) Agent pursuant to power of attorney notifies Company

3. Dissolution/termination of Member's existence as Member[92]:

a. ☐ Member's interests are repurchased
b. ☐ Member becomes an assignee

P. Consent for approval of amendments to operating agreement[93]:

1 ☐ Unanimous consent of Members for all amendments
2 ☐ Consent of _____% of Members is required for all amendments (other than those that affect a Member uniquely)
3 ☐ Consent of _____% of Members for amendments but unanimous consent for some amendments, possibly including:

a. Financial arrangements
b. Any matter requiring unanimous approval in the operating agreement
c. Admission and expulsion of Members
d. Name
e. Purpose

92. Almost every state allows members to identify specific events in the operating agreement that will result in dissolution of the LLC. *See generally* RIBSTEIN & KEATINGE, *supra* note 1, § 11:5 & app. 11-5; *see also* BISHOP & KLEINBERGER, *supra* note 1, ¶ 9.02. A few states, however, allow the continuation of an LLC following an event of dissolution only with the consent of all remaining members. *See, e.g.*, ARK. CODE ANN. § 4-32-901(3) (LEXIS through 2014 Fiscal Sess.); ARIZ. REV. STAT. § 29-781 (LEXIS through 51st Leg., 2d Reg. Sess. Emergency Legislation); WASH. REV. CODE § 25.15.270(4) (LEXIS through 2013 3d Special Sess.); *see also* RIBSTEIN & KEATINGE, *supra* note 1, § 11:7; BISHOP & KLEINBERGER, *supra* note 1, ¶ 9.01. An operating agreement should also provide for what will happen to the LLC when its last remaining member is lost. Some states allow the LLC to continue its legal existence in some limited circumstances even after the loss of the final member. *See, e.g.*, COLO. REV. STAT. § 7-80-801 (LEXIS through all laws passed at the 1st Reg. Sess. of the 69th Gen. Assemb. of the State of Colorado); KY. REV. STAT. ANN. § 275.285(4) (LEXIS through 2013 1st Extra Sess.); TEX. BUS. ORGS. CODE ANN. § 11.056 (LEXIS through 2013 3d Called Sess.).

93. In considering what level of consent to require for amendment of the operating agreement, there are two competing goals: "(1) ensuring that a large enough vote is required to avoid unfairness or blatant bias against an out-of-favor minority member and (2) ensuring that there is, in fact, some flexibility in the agreement." Coppedge, *supra* note 47, at 50. Coppedge suggests that "a range of 75%–90% approval for amendments to the operating agreement is often ideal." *Id*. It may also be desirable to require a higher percentage or unanimous vote for certain types of amendments. Certain items should require the consent of each member, e.g., change of share of profits and distributions, increased liabilities, and change-of-amendment provisions. *See* BISHOP & KLEINBERGER, *supra* note 1, ¶ 5.06[4]; RIBSTEIN & KEATINGE, *supra* note 1, § 4:16 (for a discussion on amendments to the operating agreement).

f. Authority of Members or Managers
g. Dissolution
h. Amendment procedure
i. Other: _____

_____

4. ☐ Consent of ___ % of Members and approval of non-Members[94]

Q. Will the LLC be offering interests to the public?[95]

☐ Yes

☐ No

R. Dissenters' rights in the event of merger[96]:

☐ Yes

☐ No

94. In a particular situation, it may be desired that, in order to effect an amendment of the operating agreement, that amendment be approved by persons who are themselves not members. For example, it may be required that consent of a manager, who is not a member, will be required for amendment. Another example would be an instance where a lender's consent to an amendment is required. Many loan documents will contain a covenant to the effect that any amendment of the operating agreement requires prior notice to the lender and the lender's consent. In that instance, where the operating agreement is amended without the lender's consent, there is simply a breach of the loan covenant with contractual damages flowing therefrom. Where, in contrast, the operating agreement requires the lender's consent in order for the amendment to be effective, an amendment undertaken without the lender's consent is, *ab initio*, a nullity. *See*, *e.g.*, RPLLCA § 112(a), *supra* note 5, at 139 ("If a limited liability company agreement provides for the manner in which it may be amended, including by requiring the approval of the person who is not a party to the limited liability company agreement or the satisfaction of conditions, it may be amended only in that manner or as otherwise permitted by law (except that the approval of any person may be waived by that person and any conditions may be waived by all persons for whose benefit those conditions were intended."); RULLCA § 112(a), 6B U.L.A. 449 (2008) ("An operating agreement may specify that its amendment requires the approval of a person that is not a party to the operating agreement or the satisfaction of a condition. An amendment is ineffective if its adoption does not include the required approval or satisfy the specified condition.").

95. If offered to the public, consider securities matters, entity structure, and publicly traded partnership tax issues.

96. A minority of the LLC acts provide statutory dissenters' rights to the members in the event of certain transactions, although it may be possible to eliminate this right in the operating agreement. If the organizational law provides dissenters' rights, but those are not desired, consider whether the LLC act in question provides the flexibility to modify or entirely waive those rights. Where dissenters' rights are sought and they are not provided for in the statute, they must be included in the operating agreement. Consider as well the statutory language providing for dissenters' rights in the case of, for example, a merger, and whether that language needs to be expanded to address, for example, a conversion that was subsequently added to the LLC act or is now available by reason of the adoption of the Model Entity Transactions Act (6A U.L.A. 1 (2008)) or a similar junction box statute. For a discussion of dissenters' rights, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 12.11; RIBSTEIN & KEATINGE, *supra* note 1, § 11:13.

S. Derivative actions[97]:

- ☐ Yes
  - ☐ Member only
  - ☐ Member and assignees
- ☐ No

T. Tax Matters Partner[98]:

_____

97. While some LLC acts expressly provide for derivative actions, See, for example, FLA. STAT. ANN. § 608.601 (LEXIS through 2013 Reg. Sess.); TEX. BUS. ORGS. CODE ANN. §§ 101.451–101.463 (LEXIS through 2013 3d Called Sess.), others are silent on the issue. New York's highest court held that there was a common law right to bring a derivative action that was not abolished by the passage of the LLC act. Tzolis v. Wolff, 884 N.E.2d 1005, 1016 (N.Y. 2008). If the LLC act in question does not expressly permit derivative actions and they are desired, they should be addressed in the operating agreement. Delaware permits a member or an assignee of an LLC interest to bring a derivative action. DEL. CODE ANN. tit. 6, § 18-1001 (LEXIS through 2014 Fiscal Sess.). For a discussion of derivative actions, see RIBSTEIN & KEATINGE, *supra* note 1, § 10:3; BISHOP & KLEINBERGER, *supra* note 1, ¶ 10.07; Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 BAYLOR L. REV. 63 (2006).

98. Under Code § 6221, many partnerships are subject to unified federal tax audit proceedings, which are designed to facilitate partnership tax audits by determining adjustments, to the extent possible, at the partnership level rather than requiring that the Service audit each individual partner. 26 U.S.C. § 6221 (2012). As noted above, most multi-member LLCs are considered partnerships for tax purposes. A "small partnership" is exempt from the unified audit rules. A partnership is considered a "small partnership" if it has ten or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation, or the estate of a deceased partner. *Id.* § 6231(a)(1)(B)(i). Therefore, an LLC having an S corporation or partnership as a member is not a "small partnership," regardless of size. Where an interest in an LLC is itself held by a disregarded entity, the partnership no longer qualifies as a small partnership and must have a tax matters partner. I.R.S. Gen. Couns. Mem. 200250012 (Aug. 30, 2002). A husband and wife are treated as one partner for this purpose. Even if a partnership is otherwise exempt from these rules, the partnership may elect to be subject to them. 26 U.S.C. § 6231(a)(1)(B)(ii) (2012).

Any partnership subject to the unified audit proceedings is required to have a tax matters partner. *Id.* § 6231(a)(7). The tax matters partner must be a "general partner," and it is either the general partner so designated by the partnership or the partner with the largest profits interest where no designation has been made. *See* Treas. Reg. § 301.6231(a)(7)-2 (2001) (for the determination of who is a "general partner" of an LLC and the designation of the tax matters partner of an LLC). See Rev. Rul. 2004-88, 2004-32 I.R.B. 65, regarding a "disregarded entity" as the tax matters partner. For a discussion of the small partnership exception, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 2.07[2][c]. For a discussion of tax matters partner, see *id.* ¶ 2.07[2][c][i]; RIBSTEIN & KEATINGE, *supra* note 1, § 17:19.

PART V. General Member Information

A. Classes of members[99]:

1. ☐ One class
2. ☐ Multiple classes of Members

   ☐ Differing voting rights
   ☐ Differing economic rights

   ☐ Other: _____

   _____

   _____

3. Initial voting rights[100]:

Member	Class of Voting Rights	_____ of Voting Rights
1		
2		
3		
4		
5		
6		

B. Manner of consenting:

1. Meetings with formal rules
2. Voting by proxy
3. Consent[101]

99. Some states expressly permit LLCs to have different classes of members with different rights and powers. *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-30 (LEXIS through 2014 Fiscal Sess.); TEX. BUS. ORGS. CODE ANN. § 101.104 (LEXIS through 2013 3d Called Sess.). In *Drafting Partnership and LLC Agreements*, Terence Cuff discusses potential uses for different classes of interests, such as creating common and preferred interests. *See* Cuff, *supra* note 77.

100. State law may provide a default rule that voting is per capita (members have equal vote even when ownership is not equal), pro rata based on ownership interests or otherwise. Consideration should also be given to an appropriate quorum provision. *See id.* at 45–6. For a state-by-state analysis of voting right default rules, see RIBSTEIN & KEATINGE, *supra* note 1, § 8:3 app. 8-4.

101. Alternatives include permitting consent by a unanimous written consent, by the vote of the members sufficient to pass on the matter in question at a convened meeting of the members, or by a threshold higher than that required at a convened meeting but below unanimous. The last option has the benefit of encouraging careful scrutiny when acting absent the discussion that would take place in a convened meeting.

- ☐ Unanimous of Members[102]
- ☐ Vote of Members otherwise sufficient to act
- ☐ Other: _____

_____

_____

PART VI. Information for Operating Agreement if Member-Managed

A. Methods of measuring level of authorization or consent:

1. ☐ Per capita[103]
2. ☐ By sharing ratios/units
3. ☐ By capital contributions[104]
4. ☐ By current capital account balances[105]
5. ☐ Other: _____.

B. Items requiring different levels of authorization or consent:

102. Under this option, even if the members may at a meeting act by a mere majority, when acting by written consent the approval of all the members is required. *Accord* MODEL BUS. CORP. ACT § 7.04(a) (2013). Delaware requires only the vote that would be necessary to authorize an action at a meeting. DEL. CODE ANN. tit. 6, § 18-404(d) (LEXIS through 2014 Fiscal Sess.).

103. The benefit of per capita voting (*see*, *e.g.*, TEX. BUS. ORGS. CODE ANN. § 101.354 (LEXIS through 2013 3d Called Sess.); RULLCA § 407(b)(2), (3), (4), 6B U.L.A. 483 (2008); RPLLCA § 406(b)(1), *supra* note 5, at 159) is that, assuming there is at least agreement regarding who are the members, it is easy to determine relative voting rights. Per capita voting rights avoid, in many unsophisticated LLCs, problems of valuation of different types of capital contributions (e.g., working capital versus intellectual property versus an agreement to provide services).

104. Allocating voting rights relative to capital contributions has the benefit of certainty assuming there is compliance with the requirement of a written record of contributions. However, to the extent that capital is other than paid in (e.g., an agreement to pay in capital that has not yet been called), differentiations in actual versus prospective exposure need to be addressed, as do the consequences of a failure to contribute *vis-à-vis* future voting rights.

105. If voting rights are based on capital accounts, to the extent distributions are not pro rata but rather weighted toward a particular class of members, their voting rights will be disproportionately reduced as distributions are made. Reliance, however, on capital account balances will necessitate continuous attention to their maintenance. A "record date" as to their calculation for an upcoming vote may be appropriate. In an LLC utilizing special allocations, especially if losses are anticipated, utilization of capital accounts to determine voting rights can create uncertainty.

Action	Member(s)				Other
	Managing	Majority of	Supermajority of	Unanimous Consent of	
1. Acquire property					
2. Maintain insurance					
3. Borrow funds					
4. Approve or initiate a loan from a Member					
5. Call a loan					
6. Investment of LLC funds in excess of $_____					
7. Execute documents					
8. Decisions with respect to investment of funds					
9. Maintain records					
10. Do other acts to carry on business in the usual way					
11. Cause the LLC to participate in a reorganization, merger, or conversion					
12. Dissolve the LLC					
13. Sell all or substantially all of the property of the LLC outside of the ordinary course of the LLC's business					
14. Incur indebtedness not in excess of $_____					
15. Incur indebtedness in excess of $_____					
16. Expend funds of the LLC not in excess of $_____					
17. Expend funds of the LLC in excess of $_____					
18. Construct capital improvements not in excess of $_____					
19. Construct capital improvements in excess of $_____					
20. Cause the LLC to guarantee the obligation of any person or to pledge its property to secure the obligation of any person					
21. Lend money of the LLC to any person					

Action	Member(s)				Other
	Managing	Majority of	Supermajority of	Unanimous Consent of	
22. File on behalf of the LLC under the bankruptcy or insolvency laws					
23. Cause the LLC to require a capital contribution from Members					
24. Determine the time and amounts of distributions to Members					
25. Admit an assignee as a Member					
26. Make tax elections[106]					
27. Commence litigation in the name of the LLC					
28. Enter into agreements on behalf of the LLC					
29. Exercise LLC's rights under rights of first refusal or buy/sell agreements					
30. Open bank accounts and sign checks					
31. Approve payment of compensation to Members and other agents					
32. Approve reimbursement of expenses of Managers					
33. Expel Member for cause					
34. Institute an action for judicial dissolution and winding up					
35. Admit new Member and modification of economic relationships of Members in connection therewith					

106. There is often a special provision for an election under Code § 754. 26 U.S.C. § 754 (2012).

PART VII. Information for Operating Agreement if Manager Managed

A. Initial Managers:

1. Number of Managers: _____
2. Board of Managers?[107]

   ☐ Yes
   ☐ No

3. Classes of Managers[108]

   ☐ Yes
   ☐ No

4. Names, addresses, and titles (if any) of Managers:

Manager #1

Name:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

Manager #2

Name:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

107. If the LLC is to have a board of managers or other management committee, the agreement should provide for "appointment of successors, terms of office, resignation and removal procedures, and the like." Coppedge, *supra* note 47, at 49. Voting procedures for managers should also be specified in the agreement. *Id.*

108. Certain statutes expressly provide for differentiation in the authority and duties of various managers, *see*, *e.g.*, VA. CODE ANN. § 13.1-1024(J) (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.), while other statutes do so in a less direct manner, *see*, *e.g.*, KY. REV. STAT. ANN. § 275.165(2) (LEXIS through 2013 1st Extra Sess.); TEX. BUS. ORGS. CODE ANN. § 101.252 (LEXIS through 2013 3d Called Sess.).

Manager #3

Name:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

Manager #4

Name:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

Manager #5

Name:	Taxpayer Identification Number:
Address:	Telephone Number:
	Fax Number:
	E-mail Address:

B. Qualification of Managers:

1. Must be Members?[109]

☐ Yes
☐ No

109. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.165(2)(b) (LEXIS through 2013 1st Extra Sess.) (except as required by the articles of organization or the operating agreement, managers "shall not be required to be members of the limited liability company or natural persons"); TEX. BUS. ORGS. CODE ANN. § 101.302 (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.)

2. Must be individuals?[110]

   ☐ Yes
   ☐ No

C. Selection of Managers:

1. ☐ Unanimously selected by Members
2. ☐ Selected by a majority of Members consisting of _____%
3. ☐ Managers selected by particular Members or classes of membership interests:

Member/Class	Number of Managers that Member can appoint

4. ☐ Managers selected by cumulative voting[111]
5. ☐ Special rule where Manager removed for cause

   a. ☐ All Members other than Member who appointed Manager
   b. ☐ Member who appointed Manager
   c. ☐ Same rule as for other elections or appointments
   d. ☐ Majority of Members other than Member who appointed Manager
   e. ☐ Majority of Members

("manager" may consist of one or more "persons," which are defined to include artificial persons, and specifying managers need not be members or resident of state); VA. CODE § 13.1-1024.B (LEXIS through 2014 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1, of the Gen. Assemb.) ("Managers need not be residents of this Commonwealth or members of the limited liability company unless the articles of organization or an operating agreement so require."); VT. STAT. ANN. tit. 11, § 3001(12) (LEXIS through 2013 Reg. Sess. and Acts 2014, Sp. Sess. I, c. 1 of the Gen. Assemb.) ("'Manager' means a person, whether or not a member, of a manager-managed [LLC] . . . .").

110. If an entity is appointed as the manager, either the operating agreement itself or a management agreement between the LLC and the manager should address change of control of the manager as well as its bankruptcy, dissolution, and similar events.

111. If cumulative voting is desired, the operating agreement should spell out exactly what is meant by cumulative voting. It should not be assumed in the contractual environment of the LLC that the corporate law of cumulative voting will be applied unless it is expressly incorporated into the operating agreement. For a discussion of manager management structure including manner of selection, see generally BISHOP & KLEINBERGER, *supra* note 1, ¶ 7.04.

6. ☐ Other: _____

_____

_____

_____

D. Election or appointment of Managers:

1. ☐ Periodic election of Managers

a. ☐ Annual
b. ☐ Other: _____

_____

2. ☐ Election or appointment only on the removal or departure of Manager
3. ☐ Specific succession provided in operating agreement: _____

_____

_____

E. Removal of Managers:

1. Who determines removal of Manager?

a. ☐ All Members
b. ☐ All Members who appointed Manager
c. ☐ _____% of Members who appointed Manager
d. ☐ All Members other than Member who appointed Manager
e. ☐ _____% of Members
f. ☐ _____% of Members other than Member who appointed Manager
g. ☐ All Managers other than Manager being removed
h. ☐ _____% of Managers other than Manager being removed
i. ☐ Other: _____

_____

_____

2. Removal only for cause?

☐ Yes
☐ No

a. If yes, definition of "cause":

(1) ☐ Fraud
(2) ☐ Gross negligence
(3) ☐ Bankruptcy

(4) ☐ Disability; if so, definition of disability: _____

_____

(a) ☐ Guardian/conservator appointed by court
(b) ☐ Primary care physician or designee determines inability to manage business affairs
(c) ☐ Member has not performed business functions for ___ days
(d) ☐ No performance of duties for Company in ___ days
(e) ☐ Agent pursuant to power of attorney notices Company of disability

(5) ☐ Willful misconduct
(6) ☐ Conviction of a crime
(7) ☐ Conviction of a crime against Company
(8) ☐ Violation of the operating agreement:

(a) ☐ Any violation
(b) ☐ Material violation
(c) ☐ Repeated violation
(d) ☐ Violation of particular provisions: _____

_____

_____

_____

_____

(9). ☐ Other: _____

_____

_____

3. If yes, who determines whether "for cause" factors have been met?

a. ☐ Same as determines removal of Manager above
b. ☐ Adjudication
c. ☐ Arbitration

F. Manner of consenting[112]:

1. ☐ Meetings with formal rules
2. ☐ Informal consent

112. Generally, LLC acts do not include default provisions for meetings of the members and other formal governance procedures. Rather, those procedures will be determined by the agreement of the members. The absence of standard provisions dealing with member meetings and similar issues is in striking contrast to business corporation laws. However, there are exceptions to this rule, notably Minnesota and North Dakota which, by statute, contain detailed provisions dealing with those procedural

3. ☐ Vote by proxy?[113]

G. Methods of measuring level of consent[114]:

1. ☐ Per capita
2. ☐ Other: _____

_____

H. Managers to sign operating agreement:

☐ Yes
☐ No

I. Items requiring different levels of consent[115]:

matters. *See* MINN. STAT. ANN. §§ 322B.33–.37 (LEXIS through 2014 Reg. Sess.); N.D. CENT. CODE §§ 10-32-44 through -50 (LEXIS through 2013 Reg. Sess.); *see also* N.Y. LTD. LIAB. CO. LAW §§ 403–407 (Consol. 2014); TENN. CODE ANN. § 48-222-101(a)) (LEXIS through 2013 Reg. Sess.); *id.* § 48-224-104; TEX. BUS. ORGS. CODE ANN. § 101.351–101.359 (LEXIS through 2013 3d Called Sess.); *id.* §§ 6.001–6.053.

113. There are state-specific limitations on the use of proxies in LLCs. Proxies are expressly permitted by the Revised Prototype LLC Act. *See* RPLLCA § 406(d), *supra* note 5, at 159. Issues regarding restricting the right to participate in management to those admitted as members may arise as well under a state enactment of the Uniform Power of Attorney Act. For example, the Tennessee LLC act provides that an operating agreement may not authorize a "director" of an LLC to vote by proxy. *See* TENN. CODE ANN. § 48-249-205(b)(11) (LEXIS through 2013 Reg. Sess.); *see also* Thomas E. Rutledge, *In Delectus Personae and Proxies*, J. PASSTHROUGH ENTITIES, July/Aug. 2011, at 43.

114. In LLCs, there generally exists significant flexibility with respect to the allocation of voting rights. While certain early acts provided that all members, irrespective of their economic position in the company, would have equal voting rights (*e.g.*, RPLLCA § 406(b), *supra* note 5, at 159), most acts today allocate, as a default matter, voting rights in proportion to contributions. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.175(3) (LEXIS through 2013 1st Extra Sess.); *id.* § 275.015(3). Other states do not provide a default rule, leaving the issue of allocation of voting rights entirely to the operating agreement. *See*, *e.g.*, OHIO REV. CODE ANN. § 1705.26 (LexisNexis 2001 & Supp. 2013) (the operating agreement "may grant to all or a specified group of its members the right to vote on a per capita or other basis upon any matter."). If voting rights are determined relative to capital contributions, the operating agreement should specify under what circumstances a distribution is a return of a capital contribution (e.g., that the first dollars distributed are a return of capital).

115. It is important to prevent third parties from relying on the apparent authority of managers, members, and/or officers when those persons are not actually authorized to bind the LLC. For a discussion of the power to bind the LLC in contractual undertakings, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 7.06; RIBSTEIN & KEATINGE, *supra* note 1, §§ 8:5–8:9; *see also* Rutledge, *supra* note 8; Rutledge & Frost, *supra* note 8.

Action	Manager(s)					Ratification Required by:			Other
	Single	Majority of	Supermajority of	Unanimous Consent of	Single "Super"	Majority of Members	Supermajority of Members	Unanimous Consent of Members	
1. Acquire property									
2. Maintain insurance									
3. Borrow funds									
4. Approve loan from Member									
5. Call a loan									
6. Invest LLC funds in excess of $_____									
7. Execute documents									
8. Employ professionals and other agents									
9. Decisions with respect to investment of funds									
10. Maintain records									
11. Do other acts to carry on business in the usual way									
12. Cause the LLC to participate in a merger/conversion/domestication/_____									
13. Dissolve the LLC									
14. Sell all or substantially all of the property of the LLC outside of the ordinary course of the LLC's business									
15. Incur indebtedness not in excess of $_____									
16. Incur indebtedness in excess of $_____									

Action	Manager(s)					Ratification Required by:			Other
	Single	Majority of	Supermajority of	Unanimous Consent of	Single "Super"	Majority of Members	Supermajority of Members	Unanimous Consent of Members	
17. Expend funds of the LLC not in excess of $_____									
18. Expend funds of the LLC in excess of $_____									
19. Construct capital improvements not in excess of $_____									
20. Construct capital improvements in excess of $_____									
21. Cause the LLC to guarantee the obligation of any person or to pledge its property to secure the obligation of any person									
22. Lend money of the LLC to any person									
23. Cause the LLC to commence an action in bankruptcy									
24. Cause the LLC to require a capital contribution from Members									
25. Amend the operating agreement[116]									

116. In addition to the crucial issue of determining the appropriate threshold for amendment of the operating agreement, there is as well the issue of defining exactly what constitutes the operating agreement. Generally, the "operating agreement" constitutes the agreement among the members as to the operation of the company. *See*, *e.g.*, KY. REV. STAT. ANN. § 275.015(20) (LEXIS through 2013 1st Extra Sess.); RPLLCA § 102(14), *supra* note 5, at 129; TEX. BUS. ORGS. CODE ANN. § 101.001(1) (LEXIS through 2013 3d Called Sess.). Consequently, any decision made by all of the members (or any decision made by that threshold of the members necessary to adopt an amendment to the operating agreement) arguably constitutes part of the "operating agreement." It follows that any later action to alter that previous decision is itself arguably an amendment to the operating agreement and

Action	Manager(s)					Ratification Required by:			Other
	Single	Majority of	Supermajority of	Unanimous Consent of	Single "Super"	Majority of Members	Supermajority of Members	Unanimous Consent of Members	
26. Determine the time and amounts of distributions to Members[117]									
27. Admit an assignee as a Member[118]									

will require that threshold of the members required for an amendment. For example, assume that an operating agreement requires an 80 percent vote of the members for its amendment, but allows a majority of the members to determine a matter in the ordinary course. A decision is made with respect to the carpeting in the reception area of the LLC's offices, and that decision is made by at least that threshold of the members required for amendment of the operating agreement. There is a subsequent effort to make a different color selection, one that receives in excess of the majority required for a matter in the ordinary course but less than the approval required for an amendment of the operating agreement. It may be argued that the decision to change the color scheme is ineffective in that the required vote to amend the operating agreement has not been satisfied. As such, with respect to those provisions addressing the amendment of the operating agreement as well as those provisions addressing the approval of matters either in the ordinary course or not in the ordinary course of business, keep in mind and properly address what constitutes the "operating agreement." For a discussion of the operating agreement, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 5.06. For a discussion of amendments to the operating agreement, see *id.* ¶ 5.06[4].

117. Individual LLC acts may have specific requirements for distributions. For example, Rhode Island, R.I. GEN. LAWS § 7-16-28 (LEXIS through 2013 Reg. Sess.), and Hawaii, HAW. REV. STAT. § 428-404(c)(6) (West 2008) provide a default rule for unanimous approval of the members for an interim distribution. In contrast, under the Revised Prototype LLC Act, the declaration of a distribution is an ordinary course activity requiring the approval of only a majority of the members. *See* RPLLCA § 404(a)(2), *supra* note 5, at 156; *id.* § 406(b)(1), at 159.

118. A member of an LLC may unilaterally transfer the right to receive the economic fruits of the LLC (i.e., allocation of the tax items of income, loss, deduction, and credit and interim and liquidating distributions), but may not unilaterally transfer the right to participate in the management and direction of the LLC. *See*, *e.g.*, ME. REV. STAT. ANN. tit. § 685 (West 2011). Rather, the right to participate in the management of the LLC is restricted to those who have been admitted as a member. The states have adopted a variety of default voting thresholds required for the admission of a "mere transferee" as a member. *See*, *e.g.*, CONN. GEN. STAT. § 34-172 (LEXIS through P.A. 14-211 (except 14-175, 14-187 and 14-205) (majority in interest of the members); HAW. REV. STAT. § 428-404(c)(7) (LEXIS through 2013 2d Sp. Sess.) (all of the incumbent members); KY. REV. STAT. ANN. § 275.275(1) (LEXIS through 2013 1st Extra Sess.) (all of the incumbent members); RPLLCA § 401(b)(3), *supra* note 5, at 154 (all of the incumbent members); RULLCA § 502(a)(3), 6B U.L.A. 496 (2008). For a discussion of

Action	Manager(s)					Ratification Required by:			Other
	Single	Majority of	Supermajority of	Unanimous Consent of	Single "Super"	Majority of Members	Supermajority of Members	Unanimous Consent of Members	
28. Make tax elections									
29. Commence litigation in the name of the LLC									
30. Enter into agreements on behalf of the LLC									
31. Exercise LLC's rights under rights of first refusal or buy/sell agreements									
32. Open bank accounts and sign checks									
33. Approve payment of compensation to Members and other agents									
34. Approve reimbursement of expenses of Managers									
35. Determine to expel Members for cause									
36. Institute an action for judicial dissolution and winding up									
37. Admit new Members and modification of economic relationships of Members in connection therewith									

the limitations on member's power and right to transfer, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 8.06; RIBSTEIN & KEATINGE, *supra* note 1, § 7:5.

J. Duties of managers:

1. Duty of care[119]

   a. Gross negligence
   b. Ordinary prudence
   c. Other: _____

   _____

K. Duty of Loyalty:

1. Right to compete[120]:

   a. ☐ Yes
   b. ☐ No
   c. ☐ Yes, but limited to _____.
   d. ☐ No, but may invest in entities competing with Company if no management rights and investment in other entity does not exceed a _____% interest in the competing venture.

2. Duty to offer opportunities to the LLC[121]:

   ☐ Yes, as to _____.
   ☐ No

119. The default standard of care in Delaware for imposing liability is gross negligence. Werner v. Miller Tech. Mgmt't, L.P., 831 A.2d 318, 331 (Del. Ch. 2003) (citing *In re* Limited, Inc., Civ. A. No. 17148-NL, 2002 WL 537692 (Del. Ch. 2002)); Guttman v. Huang, 823 A.2d 492, 507 n.39 (Del. Ch. 2003) (the "litmus test" in Delaware for imposing liability for breach of the fiduciary duty of care, absent a more exculpatory provision in the entity's governing documents, is gross negligence). To establish the gross negligence of the manager, a member must plead and prove that the manager was "recklessly uninformed or acted outside the bounds of reason." Cincinnati Bell Cellular Sys. Co. v. Ameritech Mobile Phone Serv. of Cincinnati, Inc., No 13389, 1996 WL 506906, at *4 (Del. Ch. 1996) (quoting Tomczak v. Morton Thiokol Inc., No. 7861, 1990 Del. Ch. LEXIS 47, at *35 (Apr. 5, 1990), *aff'd*, 692 A.2d 411 (Del. 1997). LLC acts have addressed the standard of care owed by managers and managing members in a variety of ways. *See* J. William Callison & Allan W. Vestal, "*They've Created a Lamb with Mandibles of Death*"; *Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Firms*, 76 IND. L.J. 271, 281–91 (2001). Several LLC acts adopt a standard of care akin to gross negligence. *See*, *e.g.*, FLA. STAT. ANN. § 608.4225(b) (LEXIS through 2013 Reg. Sess.) ("The duty of care is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."); KY. REV. STAT. ANN. § 275.170(1) (LEXIS through 2013 1st Extra Sess.) ("[A] member or manager shall not be liable, responsible, or accountable in damages or otherwise to the [LLC] or the members of the [LLC] for any action taken or failure to act on behalf of the [LLC] unless the act or omission constitutes wanton or reckless misconduct."); RULLCA § 409(c), 6B U.L.A. 488 (2008) (applying, subject to the business judgment rule, a standard of ordinary negligence). Other states adopt various standards including good faith, ordinary negligence, and acting "[i]n a manner believed to be in the best interests of the company." *See* Callison & Vestal, *supra* at 283. Statutes based upon ULLCA or RULLCA provide that the operating agreement may not "unreasonably reduce" the standard of care and leave the operating agreement free to impose more strict standards. *See* RULLCA § 110(d)(3), 6B U.L.A. 442 (2008). For discussions of the duty of care, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 10.02; RIBSTEIN & KEATINGE, *supra* note 1, § 9:2.

120. The enforceability of covenants not to compete is largely dependent on state law. Terence Floyd Cuff, *Drafting Partnership and LLC Agreements: Part 4*, BUS. ENTITIES, Nov./Dec. 2001, at 12.

121. The extent to which, if at all, members and managers of an LLC must present opportunities germane to the LLC's business or may engage in other business activities is a subject that usually re-

3. Expectation that Manager will have other activities:

   ☐ Yes
   ☐ No

4. Other duty of loyalty issues: _____

L. Good Faith/Fair Dealing[122]

M. Member approval of conflict of interest transaction:

   ☐ Unanimous

   ☐ _____

N. Standard for judicial approval of conflict of interest transactions between LLC and Managers:

   ☐ Entire fairness
   ☐ Arm's length[123]

---

quires particular attention and negotiation when organizing a venture. Care needs to be taken to reconcile the provision with the purpose of the LLC (Item IV(a)(2) and note 35 above).

122. An operating agreement is a contract, and as such incorporates an implied duty of good faith and fair dealing. *See*, *e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement"). Under RULLCA § 110(c)(5), an operating agreement may not eliminate the obligation of good faith and fair dealing, set forth expressly in that act in section 409(d), but the operating agreement may prescribe the standard by which the performance of the obligation of good faith and fair dealing will be measured. RULLCA § 110(d)(5), 6B U.L.A. 442 (2008), *see also* DEL. CODE ANN. tit. 6, § 110(b)(1) (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.003(7) (LEXIS through 2013 1st Extra Sess.); RPLLCA § 110(b)(1), *supra* note 5, at 136; *id.* § 110(c)(5). There is, however, significant disagreement as to the meaning of "good faith." For example, in *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006), the Delaware Supreme Court determined that good faith is a "subsidiary element" of the duty of loyalty. The scope of what constitutes good faith or the absence of bad faith is recognized as being murky at best. In the *Disney* decision the Delaware Chancery Court acknowledged that it likely is impossible to articulate a broad enough definition to capture the 'universe of acts that would constitute bad faith. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005); *see also* Comm. on Corporate Laws, ABA Bus. Law Section, *Changes in the Revised Model Business Corporation Act—Amendment Pertaining to the Liability of Directors*, 45 BUS. LAW. 695, 697 (1990). The phrase "acts or omissions not in good faith" is "easily susceptible to widely differing interpretations, especially retroactively," and was determined to be too imprecise a standard or duty to be barred from being waived in a corporation's certificate of incorporation. Instead, the breadth of what might constitute nonwaivable bad faith has been narrowed under the Model Business Corporation Act to include acts or omissions (i) with respect to which the director derives a financial benefit to which he or she is not entitled or (ii) that are either intentionally criminal or intentionally designed to harm the corporation.

The *Disney* decision refers to the case law in this area as a "fog of . . . hazy jurisprudence," but "[t]o act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation," which includes not intentionally disregarding his or her duties as a fiduciary. Be aware that "good faith" may be a fiduciary obligation while "good faith and fair dealing" is a rule of contract law.

123. For a case interpreting and applying a similar "arm's-length" provision in an operating agreement, see *Flight Options International, Inc. v. Flight Options, LLC*, C.A. No. 1459-N, 2005 WL 6799224 (Del. Ch. 2005), concluding that the basis for evaluating a transaction under that standard is whether the price and other terms of the transaction "would have been the outcome of an arm's-length negotiation." In that case, absent a process for ratifying the manager's determination that the terms of a self-interested transaction were equivalent to what would have been negotiated in an arm's-length

O. Management fee and arrangement[124]: _____

_____

_____

P. Titles of certain Managers, if any: _____

_____

_____

Q. Compensation of Managers, if any[125]: _____

_____

_____

R. Manager information[126]:

1. ☐ All books and records
2. ☐ Same rights as Members
3. ☐ All books and records pertinent to discharge of responsibilities as Manager
4. Other (describe): _____

_____

_____

S. Exculpation and indemnification of Managers.

transaction, the court concluded that the manager had the burden of demonstrating that its determination met that standard.

124. Holding equity in an LLC, including a "carried interest," typically makes the manager a partner for tax purposes. *See* Rev. Rul. 69-184, 1969-1 C.B. 256.

125. Compensation of the managers needs to be addressed either in the operating agreement or in a separate management agreement between the LLC and the manager. Note that, if the manager is not a member, under most LLC acts the manager will have no voice with respect to amendment of the operating agreement, including those provisions addressing the manager's responsibilities and compensation. For that reason, some managers may prefer that all compensation issues be set forth in a separate management agreement so that it constitutes a bilateral agreement between the LLC and the manager that is enforced separately from the operating agreement. In contrast, where the manager is also a member, care must be taken to correctly describe the compensatory relationship as distinct from the economic rights of membership.

126. While some LLC acts expressly afford managers rights to inspect the books and records of the LLC (*see*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-305(b) (LEXIS through 2014 Fiscal Sess.)), many LLC acts are silent as to a manager's right to access books and records. To the extent the state's statute is silent or to the extent it contains a provision that is modifiable and modification is desired, the topic should be addressed in the operating agreement.

PART VIII. Other Matters

A. Foreign qualifications[127]:

- ☐ Yes
- ☐ No

If yes, specify where and registered agent/office. Keep in mind that each state has its own requirements as to when state registration is required.

State	RO/RA

B. Capital contribution/subscription agreement needed[128]:

- ☐ Yes
- ☐ No

If yes, then provide for:

1. Disclosure that membership interests are not registered securities
2. Acquisition of membership/economic interests
3. Acceptance of contribution; consideration
   a. Cash
   b. Letter of credit
   c. Secured promissory note
   d. Personal guaranty of company debt (if permitted by state law)

127. Care needs to be taken at the time of organization to investigate the laws of the foreign states in which the LLC will do business or own assets in order to determine whether qualification to transact business will be required, consequences for failure to do so, and, more importantly, whether the LLC and its members may be subject to tax in the state. Thereafter, the issue needs to be continuously reviewed to account for actual business activities. *See generally* BISHOP & KLEINBERGER, *supra* note 1, ¶ 5.09; RIBSTEIN & KEATINGE, *supra* note 1, § 13:3.

128. A subscription agreement usually will include standard securities law (including applicable state Blue Sky laws), representations and warranties, and a questionnaire establishing the prospective member to be an accredited investor under Regulation D promulgated under the Securities Act of 1933. For a discussion of the relationship of federal and state securities laws to LLC membership interests, see BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 11.01–.03; RIBSTEIN & KEATINGE, *supra* note 1, § 14:2.

4. Representations as to investor suitability standards; other standards
5. Representations as to non-foreign-person status; residence
6. Representations that all requested information was made available
7. Representations that investment intent only
8. Indemnification as to representations; security therefor
9. Transferability
10. Consider legal review of other offering documents
11. Other: _____

_____

_____

C. Business already in operation as a general or limited partnership or sole proprietorship:

☐ Yes
☐ No

1. Transfer of documents of assets in exchange of capital contribution

   a. Bill of sale for assets (request listing from client)
   b. Assignment for intangible assets and other assets

2. Tax considerations for initial contribution (book-up; taxable event, etc.)

D. Tradename registrations with Secretary of State: _____

_____

E. Advice given that name registration of company and of tradename do not give trademark protection:

☐ Yes
☐ No

Intellectual property work referred to: _____

F. Name of tax and other advisors:

1. Tax advisor

Name:	Telephone Number:
Address:	Fax Number:
	E-mail Address:

2. Estate planning attorney

Name:	Telephone Number:
Address:	Fax Number:
	E-mail Address:

3. Financial advisor

Name:	Telephone Number:
Address:	Fax Number:
	E-mail Address:

4. Other advisor

Name:	Telephone Number:
Address:	Fax Number:
	E-mail Address:

PART IX. Dissolution, Winding Up, and Termination[129]

A. Voluntary Dissolution:

1. Consent of members[130]

129. *See generally* BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 9.01–.06; RIBSTEIN & KEATINGE, *supra* note 1, § 11:5 app. 11-5.

130. The states set a variety of default thresholds for voluntary dissolution. *See*, *e.g.*, ALA. CODE § 10-12-37(2) (LEXIS through 2014 Reg. Sess.) ("written consent of all members"); ARK. CODE ANN. § 4-32-901(2) (LEXIS through 2014 Fiscal Sess.) ("written consent of all members"); CONN. GEN. STAT. § 34-206(2) (LEXIS through P.A. 14-211 (except 14-175, 14-187 and 14-205)) ("at least a majority in interest of the members"); MD. CODE ANN., CORPS. & ASS'NS § 4A-902(a)(2) (LEXIS Emergency Leg. through 2013 2d Reg. Sess.) ("the unanimous consent of the members"); R.I. GEN. LAWS § 7-16-39(3) (LEXIS through 2013 Reg. Sess.) ("majority of the capital values of all membership interests which have not been assigned"); TEX. BUS. ORGS. CODE ANN. § 101.552 (LEXIS through 2013 3d Called Sess.) ("a majority vote of all the members"). Often the statute expressly permits modification of this threshold. *See*, *e.g.*, CONN. GEN. STAT. § 34-206 (LEXIS through P.A. 14-211 (except 14-175, 14-187 and 14-205)) ("unless otherwise provided in writing in the

a. ☐ Unanimous consent of Members or classes of Members
b. ☐ Consent of _____ Members or _____% of Members
c. ☐ Will of any one Member
d. ☐ Other: _____.

2. Specific event

a. ☐ Upon sale of substantially all assets of the LLC[131]
b. ☐ Event making it unlawful to carry on business
c. ☐ Dissociation of key person
d. ☐ Date or event certain
e. ☐ Other: _____

B. Involuntary dissolution:

1. Judicial dissolution[132]

2. Administrative dissolution[133]

a. Authority to reverse administrative dissolution?

articles of organization or operating agreement,"); R.I. GEN. LAWS § 7-61-21(b) (LEXIS through 2013 Reg. Sess.) ("Unless otherwise provided in the articles of organization or operating agreement."); TEX. BUS. ORGS. CODE ANN. § 101.052 (LEXIS through 2013 3d Called Sess.) (company agreement controls except as to specified non-waivable matters). For a discussion of voluntary dissolution by the consent of members, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 9.02[3]; RIBSTEIN & KEATINGE, *supra* note 1, § 11:5.

131. This is a difficult definition, and consideration should be given to defining it in the operating agreement.

132. State LLC acts provide for judicial dissolution under specified circumstances. They typically include, at minimum, circumstances where it is not reasonably practicable to carry on the business in conformity with the operating agreement. *See*, *e.g.*, DEL. CODE ANN. tit. 6, § 18-802 (LEXIS through 2014 Fiscal Sess.); KY. REV. STAT. ANN. § 275.290 (LEXIS through 2013 1st Extra Sess.); N.Y. LTD. LIAB. CO. LAW § 702 (Consol. 2014); TEX. BUS. ORGS. CODE ANN. § 11.314 (LEXIS through 2013 3d Called Sess.). Some states also provide for judicial dissolution in the event of a deadlock. *See* FLA. STAT. ANN. § 608.449(2)(a) (LEXIS through the 2013 Reg. Sess.). Certain states may permit the operating agreement to provide for additional bases for judicial dissolution. Despite state statutes providing for judicial dissolution, it can be very difficult to obtain. *See* Allan G. Donn, *Freedom of Contract and Boilerplate Provisions of Business Entity Agreements*, J. PASSTHROUGH ENTITIES, Mar./Apr. 2005, at 11, 16–18. For discussions on judicial dissolution, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 9.02[7]; RIBSTEIN & KEATINGE, *supra* note 1, § 11:5. Under Delaware law, it is possible for the operating agreement to waive the right to judicial dissolution. *See* R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803-CC, 2008 Del. Ch. LEXIS 115 (Aug. 19, 2008). Conversely, under RULLCA, judicial dissolution of an LLC is justified on the bases set forth in subsections (4) and (5) of section 701(a). *See* RULLCA § 701(a), 6B U.L.A. 506 (2008). RULLCA provides that the operating agreement may not "vary the power of a court to decree dissolution in the circumstances specified in Sections 701(a)(4) and (5)." RULLCA § 110(c)(7), 68 U.L.A. 442 (2008). Consequently, in a jurisdiction in which RULLCA has been adopted (and presuming no modification of those provisions in the state enactment), it would not be possible to eliminate the right of a member to move, on the statutorily defined basis, for judicial dissolution of an LLC.

133. For example, administrative dissolution for failure to pay taxes or file an annual report. KY. REV. STAT. ANN. § 14A.7-010 (LEXIS through 2013 1st Extra Sess.) (administrative dissolution for failure to file annual report, maintain a registered agent and office, or for failure to respond to interrogatories from the Secretary of State); TEX. BUS. ORGS. CODE ANN. § 11.251 (LEXIS through 2013 3d Called Sess.) (involuntary termination by Secretary of State on various grounds); TEX. TAX CODE ANN. § 171.251 (LEXIS through 2013 3d Called Sess.); *id.* § 171.301 (administrative forfeiture for failure to file report or return). For a discussion on administrative dissolution, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 9.02[6].

3. Agreement to allow a court-ordered dissolution[134]

   a. Oppression[135]
   b. Inability to operate except at a loss[136]
   c. Deadlock
   d. Not reasonably practical standard

4. Winding up[137]

   a. Who has authority to wind up?
   b. Articles or certificate of dissolution
   c. Publication requirement (notice to known and unknown creditors)
   d. Change in fiduciary duties?

5. Termination[138]

PART X. Dispute Resolution

A. Mediation required[139]:

   ☐ Yes
   ☐ No

134. Consider whether an operating agreement can bestow subject matter jurisdiction of this nature on a court. For example, "if X occurs, dissolve under supervision of court."

135. This is another vague concept that is subject to different interpretations. Consider defining in operating agreement.

136. Entities often operate at a tax loss and guaranteed payments may be structured to generate a loss for tax purposes, so this limitation may not be appropriate.

137. This is the process of settling accounts and liquidating assets for the purpose of final distributions to the members. *See generally* BISHOP & KLEINBERGER, *supra* note 1, ¶ 9.03; RIBSTEIN & KEATINGE, *supra* note 1, § 11:8. Consider providing for who shall be responsible for filing documents, paying creditors, and marshaling assets. Coordinate with tax advisor regarding timing and characterization of payments, and state and federal filings.

138. It is important to appreciate that the "termination" of an LLC is separate and distinct from its dissolution. The statutes generally provide that the dissolution of an LLC is simply the description of a stage of its existence, typically one during which the LLC is restricted to activities appropriate to its winding up and liquidation. *See*, *e.g.*, ALA. CODE § 10A-5-7.04(a) (LEXIS through 2014 Reg. Sess.); KY. REV. STAT. ANN. § 275.300(2) (LEXIS through 2013 1st Extra Sess.); RPLLCA § 707(a), *supra* note 5, at 176; RULLCA § 702(b)(2)(F), 6B U.L.A. 507 (2008); *see also* BISHOP & KLEINBERGER, *supra* note 1, ¶¶ 9.03[1], 9.06 (federal tax consequences). Typically, except as otherwise provided therein, the operating agreement, along with its various obligations and responsibilities, will continue to be in place and enforceable during the winding up and liquidation phase. The operating agreement should address when in the winding up and liquidation phase the obligations existing under the operating agreement will come to an end. For example, a provision in the operating agreement precluding any members from competition with the company should not remain in place indefinitely after dissolution. At the same time, however, it may be inappropriate to provide that it ends upon the filing of the articles of dissolution because doing so may diminish the value of company assets in liquidation. Likewise, obligations to pay compensation to a manager need to be addressed so those do not continue as indefinite obligations.

139. Generally, this is a non-binding procedure before a single neutral third-party mediator who does not judge the case but helps facilitate a discussion and eventual resolution of the dispute. Details that should be included in a mediation provision include: (1) notice to other parties; (2) timing issues; (3) appointing a mediator; (4) obligation to mediate in good faith; and (5) obligation to provide funds to satisfy costs of mediation.

B. Arbitration[140]:

☐ Yes
☐ No

1. Initiation of arbitration:

a. Who?_____

b. How?_____

2. ☐ Single arbitrator
or

☐ Panel[141]

3. Selection

☐ _____

☐ _____

4. Rules applied to arbitrators

☐ Evidentiary: _____

☐ Procedural: _____

☐ Substantive: _____

5. Require written decision

☐ Yes
☐ No

6. Exclusive remedy

☐ Yes
☐ No

7. Binding

☐ Yes
☐ No

8. Limitations on damages

☐ Yes; _____
☐ No

140. If arbitration is selected over litigation as the form for dispute resolution, the operating agreement needs to address the provider, forum and venue, and cost shifting (if any) that would be applicable in the case of litigation.

141. For example, each party will select an arbitrator and the two selected arbitrators will select a third arbitrator.

C. Waiver of jury trial[142]:

- ☐ Yes
- ☐ No

D. Choice of venue:

- ☐ Yes
- ☐ No

PART XI. Series

A. Is LLC being organized in a jurisdiction with series?[143]

- ☐ Yes
- ☐ No

B. Are series desired?[144]

- ☐ Yes
- ☐ No

142. Waiver of jury trial clauses are generally enforceable everywhere except Georgia and California. *See* Bank S. v. Howard, 444 S.E.2d 799, 800 (Ga. 1994) (pre-dispute contractual waivers of jury trials unenforceable in cases tried under Georgia law); Grafton Partners L.P. v. Superior Court, 36 Cal. 4th 944, 967 (2005).

143. Currently several states permit series LLCs. Series are provided for as well in the Revised Prototype LLC Act. RPLLCA §§ 1101–1116, *supra* note 5, at 210–22.

144. The series concept arose in the context of statutory trusts utilized for asset securitization and the organization of investment companies/mutual funds. *See* Thomas E. Rutledge, *Again, for the Want of a Theory: The Challenge of the "Series" to Business Organization Law*, 46 AM. BUS. L.J. 311, 313–14 (2009). In recent years the concept has spread to LLCs, and the utilization of the series concept has expanded beyond its original applications. Still, there remain significant issues with respect to the utilization of the series, including with respect to (i) the treatment of the series under bankruptcy law; (ii) whether the "internal shields" will be respected in jurisdictions in which the series is not incorporated into the domestic LLC act; (iii) federal tax classification, including whether an individual series is an "eligible entity" able to independently elect its classification; (iv) issues of state tax classification; (v) issues of nexus for purposes of state tax treatment; (vi) issues of apportionment, for purposes of state taxation, between individual series and between a series and the parent LLC; (vii) issues with respect to the granting of a security interest in assets that are associated with but not titled in the names of a particular series; (viii) issues, in the states that do not expressly provide a rule, as to whether an individual series may contract in its own name, sue and be sued in its own name, or hold title to property in its own name. *See also* Prefatory Note to RULLCA, 6B U.L.A. 408 (2008); Rutledge, *supra* at 321–26.

C. Authority to organize an individual series[145]:

- ☐ Managers
- ☐ Members

D. Membership of series:

- ☐ LLC
- ☐ All Members
- ☐ Other

E. Management of series[146]:

- ☐ Managers of Parent LLC
- ☐ Series-Specific Managers
- ☐ Members
- ☐ Other

F. Form Series Agreement.[147]

PART XII. Representations and Warranties

A. For any Member that is an entity, due formation and valid existence.

B. Member has read the agreement.

C. Member not named on OFAC SDN List.

D. Representation of accredited investor status and other disclosures required pursuant to applicable federal and state securities laws.

145. Determine whether the authority to organize an individual series of the LLC and associate LLC property therewith will be a determination of the managers or the members and the appropriate threshold thereof.

146. The LLC acts providing for series universally provide that the individual series may have management different from that of the "parent" LLC. In an operating agreement for a series LLC, a provision needs to be made for how each series will be managed.

147. A form series agreement has been published. *See* WHITMIRE DRAFTING, *supra* note 65, at. A.28.

PART XIII. Schedule of Responsibilities

Task	Party Responsible	Promised to Client by
Articles/Certificate of organization		
File immediately? Yes/No Delayed effective date? Yes/No		
Operating agreement		
Capital contribution agreement[148]		
Manager employment agreement(s)		
Member employment agreement(s)		
Equity compensation documents		
Subscription agreements		
Bills of sale for capital contribution		
Assignments for capital contribution		
Tax identification number (SS-4)		
State revenue initial filing registration		
Company minute book		
Foreign state qualifications		

148. In many instances the LLC and the contributing member will enter into a separate contribution agreement or will add more detailed information concerning the contributed property in schedules or exhibits to the operating agreement. It often is good practice to have some or all of the members execute subscription agreements, purchase agreements, or contribution agreements that contain representations, warranties, and covenants for transactions of this nature. A contribution agreement between the LLC and the contributing member often is appropriate when property other than money is contributed. That agreement will be similar to a purchase and sale agreement for the property involved. It usually will include customary representations, warranties, and covenants in respect of the property being conveyed to the LLC. For analysis of capital-related obligations imposed by LLC statutes, see BISHOP & KLEINBERGER, *supra* note 1, ¶ 6.05; RIBSTEIN & KEATINGE, *supra* note 1, §§ 5:1–.8.