EXHIBIT C –

COMMON LLC DRAFTING ERRORS

By Alan S. Gassman

Over and over again we review Operating Agreements prepared by lawyers, clients, and sometimes even accountants that pose significant problems for clients.

The top ten mistakes that we see are as follows:

1. Failure to have a properly signed Operating Agreement.

How do you verify ownership, tenancy by the entireties status, or the tax status of a limited liability company without having an Operating Agreement?

2. Failure to match the Operating Agreement with the tax treatment of the entity.

This is particularly perilous where an LLC that has elected S Corporation status has a standardized Operating Agreement that makes S Corporation status impossible because of provisions inadvertently creating a second class of stock or partnership tax treatment, or having buy-sell arrangements that are not permitted under the S Corporation rules.

Anyone who drafts Operating Agreements for LLCs that may or will be taxed as S Corporations needs to take these somewhat complicated rules into account.

A common example of a fatal flow would be to have the ownership interest of a selling member valued at less than adjusted book value as defined in the second class of stock Treasury Regulations for buy-sell purposes.

3. Failure to assure that the six unities of tenancy by the entireties are provided.

Oftentimes, some or all of a limited liability company will be owned by a husband and wife who want to have tenancy by the entireties creditor protection. If any of the six unities (possession, interest, title, time, survivorship, and marriage) are inconsistent in the LLC Operating Agreement, then the creditor protection can be destroyed. A savings clause is also a very good idea.

4. Failure to have a legitimate member to facilitate having the LLC be a multiple member LLC under Florida Statute Section 608.433.

Many clients expect to have charging order protection, meaning that a creditor holding a judgment against a member cannot levy upon the member's ownership interest.

After the *Olmstead* Florida Supreme Court case, the Florida legislature enacted new language for Florida Statute Section 608.433, which provides for charging order protection in a multiple member LLC where the LLC has one or more members that are not debtors of the same obligation.

If creditors have judgments against all of the members and no member has a realistic chance of ever receiving a distribution, will any of the other owners be considered to have a membership interest?

And when a new member buys in, the new member should typically purchase his or her membership interest from the LLC itself, and not from any member who might have an insolvency issue. This helps to avoid an argument that the transfer of a membership interest to a new member is a fraudulent transfer that should be set aside.

5. Thinking that charging order protection is the answer to all potential problems.

While we have seen that a great many creditors will settle claims for nickels on the dollar when their only recourse to assets is a charging order, some creditors will put the charging order in place and ask the court of equity to allow monitoring and to limit loans, compensation, or other activities of the entity. This can work a significant hardship upon clients.

Why not place some or all of the LLC membership interests into an asset protection trust a few years after the LLC has been established? If a judge were to set aside the asset protection trust then charging order protection should still apply, so the asset protection trust is a "belt" and the charging order status is "suspenders." The new low cost of trusteeship services in asset protection jurisdictions, coupled with the estate tax purpose of establishing a creditor protection trust that can be a complete gift for tax purposes, (while possibly permitting the Grantor to benefit from the trust under certain circumstances), can clearly present a home run scenario under proper circumstances.

Having assets set aside in an irrevocable creditor protection trust can also be helpful to make sure that those assets stay separate in the event of a subsequent marriage. Also, why not go to Las Vegas to visit your trustee?

Asset protection trusts are certainly not suited for the majority of clients, but those who are well suited should have the option to better protect their assets in this manner.

6. Failure to have the LLC Operating Agreement can be an executory contract under the bankruptcy rules in case the client ends up in bankruptcy.

The case law is clear that the bankruptcy courts can allow a trustee in bankruptcy to seize a membership interest in an LLC unless the LLC Operating Agreement is an executory contract that provides contractual obligations with a material business purpose that will apply to any member, creditor, or trustee that would take over the member's interest. It is therefore important to have legitimate and normal obligations requiring members to do things such as making additional capital contributions when capital calls are mad, attending meetings, and taking an active interest in the LLC to the extent consistent with the general business objectives and responsibilities associated therewith.

7. Failure to update the Operating Agreement when changes take place with respect to ownership, tax treatment, buy-sell arrangements, or otherwise.

Modern technology allows a client or a non-lawyer to go to the Secretary of State website to establish an LLC and to receive Operating Agreement forms. This is often problematic because the client may not know which state works best for his or her particular situation, may incorrectly fill out the forms or even use the wrong forms. Further, many clients neglect to update these Operating Agreement forms, which could cause the Operating Agreement to improperly reflect the true intentions of the parties. Individuals, families, and companies who use these technologies without sound business tactics, estate planning, and creditor protection advice will often run into serious problems in the future.

8. Faulty discount planning.

Historically, a great many clients have used limited liability companies to facilitate obtaining discounts upon death for federal estate tax purposes, as well as for gifting purposes. Many complicated rules apply in this area, but, in many cases, clients and advisors are unaware of these opportunities and the rules that relate thereto.

Also, a reverse discount issue now applies whereby many clients who had LLCs structured to obtain discounts will now want to reverse the discounting mechanisms to obtain a full stepped-up basis for income tax purposes on death if the estate tax is less of a concern than the income tax.

It will be a mistake for many clients to not at least consider this option if they do not project to have taxable estates for estate tax purposes.

9. Vague provisions.

As lawyers, we are often asked to review agreements between parties to determine legal rights and obligations. When non-lawyers draft agreements, they often use language that is not clear or does not mean the same thing as intended. We often tell clients that if "we cannot understand what you meant or you cannot understand what you meant, how is a judge and jury to understand what you meant?" An Operating Agreement between multiple members becomes the constitution and foundation of their relationship. Oftentimes, it is forgotten that multiple individuals or entities engaged in business need to address the "what if" contingencies to avoid disputes and uncertainty in the future.

10. Failure to draft around a possible monetization event upon withdrawal of an LLC member.

One commentator has indicated that under the Florida law, a trustee in bankruptcy of a bankrupt limited liability company member could force that member's interest to be redeemed, unless the LLC's Articles of Organization or Operating Agreement explicitly prohibit such action. The relevant portion of the applicable statute, Section 608.4237, reads as follows:

A person ceases to be a member of a limited liability company upon the occurrence of any of the following:

> 608.4237 Membership termination upon events of bankruptcy.—A person ceases to be a member of a limited liability company upon the occurrence of any of the following:

> (1) Unless otherwise provided in the articles of organization or operating agreement, or with the written consent of all members, a member:
> (a) Makes an assignment for the benefit of creditors;
> (b) Files a voluntary petition in bankruptcy;
> (c) Is adjudged a bankrupt or insolvent, or has entered against the member an order for relief, in any bankruptcy or insolvency proceeding;
> (d) Files a petition or answer seeking for herself or himself any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation;
> (e) Files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against the member in any proceeding of this nature; or
> (f) Seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the member or of all or any substantial part of the member's properties; or

Further, Subsection (2) of Section 608.427 reads as follows:

> (2) Upon withdrawal, a withdrawing member is entitled to receive any distribution to which the withdrawing member is entitled under the articles of organization or operating agreement, and, if not otherwise provided in the articles of organization and operating agreement, the withdrawing member is entitled to receive, within a reasonable time after withdrawal, the fair value of the withdrawing member's interest in the limited liability company as of the date of resignation based upon the withdrawing member's right to share in distributions from the limited liability company.

Apparently, the legislature intended that a bankrupt or insolvent LLC member would be bought out of the LLC. However, the amendment to Florida's LLC charging order statute (Florida Statute Section 608.433(4)), which strengthens charging order protection for Florida LLCs, would indicate to the contrary. Fortunately, the concept of ipso facto[1] would probably cause the bankruptcy code to invalidate the effect of the Florida Statutes for bankrupt debtors, but to prevent this from being an issue, an LLC's Articles of Organization and/or Operating Agreement can include language that overrides the undesired result. If an LLC is established by an accountant or friend with an "office store form" Operating Agreement, members may find themselves in a trap!

Before converting a regular company into an LLC to have the advantage of charging order protection, a number of considerations will apply.

While Florida Statute Section 607.1112 permits the conversion of a regular corporation to an LLC, and specifically provides that the LLC will be considered to be a continuation of the company, as to identity, contractual rights, assets, liabilities, and other characteristics, third parties and some governmental agencies will not necessarily recognize or follow this statute.

[1] Merriam-Webster Unabridged Dictionary (Online) defines ipso facto as follows - by that very fact or act : as an inevitable result, Merriam-Webster Unabridged Dictionary (Online)

Planners should consider the following in determining whether to convert a regular corporation to an LLC or other entity.

1. Whether the conversion may violate loan or other agreements with third parties that the company may have entered into.

2. Whether the conversion will be considered to be a transfer of a licensed business or professional practice for purposes of state Department of Business Regulation rules. For example, the Florida Department of Business Regulation has taken the position that the conversion of a construction firm from a regular corporation to an LLC constitutes a change of ownership, thus necessitating significant application and associated registration changes.

3. If the company owns an airplane, the Federal Aviation Association may need to be notified to pre-approve the transition.

4. Liability or casualty insurance policies may require notification of agencies and carriers.

5. A fictitious name notice whereby the LLC is doing business under its previous name will be advisable if the previous name will be used, and some state laws prevent a limited liability company from using a fictitious name that would imply that it is a regular corporation.

6. The IRS and any state tax law authorities should be notified of the name change.

7. If the entity is a medical practice, then Medicare and Medicaid should be informed, and will treat this as a name change.

8. If the company owns real estate, copies of the Articles of Amendment should be filed in the county records to change the name of record for the company.

TAX NOTE - .When a regular corporation or P.A. is converted to an LLC, it will be considered for income tax purposes to have liquidated if there is only one owner, or to become a partnership if there are multiple owners, unless a Form 8832 is duly filed to allow for continuation of C corporation or S corporation status. Otherwise, the company will be considered to have sold its assets at fair market value and to have distributed them to the owner or owners.