Avoiding Legal Malpractice in LLC Formations

by Gianfranco A. Pietrafesa

This article highlights the issues an attorney needs to be aware of when forming a limited liability company (LLC) in New Jersey. By being aware of the issues, and following some practical suggestions, an attorney can minimize or even avoid claims of legal malpractice when forming an LLC.[1]

This is not, however, an article on how to form an LLC or draft an operating agreement. Nor does this article address the elements of a cause of action for legal malpractice or the defenses available to such a claim.[2] Nor does it address ethical issues, such as identifying and addressing conflicts of interest and confirming the fee arrangement in writing.[3]

Choice of Entity—Know the Differences between LLCs and Corporations

When asked to form an LLC, an attorney should question a client to determine whether an LLC is the proper type of entity to be formed. Although LLCs are the entity of choice, comprising over 80 percent of all entities formed in New Jersey,[4] sometimes there are good reasons to form a corporation. One example would be if the client wants to offer stock options to key employees. Although LLCs may offer something similar to stock options, the client needs to know the challenges and complexities of using an LLC instead of a corporation in this regard. Therefore, an attorney needs to know the basic differences between LLCs and corporations.

One difference involves the number of formalities that must be observed by a corporation vis-à-vis an LLC. A corporation requires an organizational meeting to adopt bylaws, elect officers, issue shares of stock, etc.,[5] and annual meetings of shareholders to elect directors.[6] By contrast, an LLC is not required to observe such formalities.[7]

Another difference involves management. A corporation has a centralized management where shareholders elect directors and the board of directors elects officers.[8] The directors and

officers, not the shareholders, manage the corporation.[9] By contrast, an LLC may be member-managed or manager-managed,[10] and an LLC provides its owners with the flexibility to define the management structure in its operating agreement.[11] An LLC may have centralized management (like a corporation), be managed by one or more managers (like a limited partnership), or be managed by all members (like a general partnership).

Another difference involves transfers of equity. In a corporation, shareholders may freely transfer shares of stock (unless there is a shareholders agreement restricting such transfers).[12] In an LLC, however, members may transfer only economic rights (*i.e.*, the right to receive income allocations and cash distributions). A person receiving an LLC interest receives an economic interest and is a transferee. Such a person will not become a member (which gives him or her certain rights, such as the right to vote and manage the LLC) unless the other members agree to allow him or her to become a member of the LLC.[13]

Understand Basic Differences in Taxation

An attorney forming an LLC also needs to know the basic tax differences between LLCs and corporations; for example, pass-through versus double taxation. A single-member LLC is a disregarded entity, and its income and other tax items are reported on Schedule C of the sole member's personal income tax return. A multimember LLC is considered a partnership for tax purposes, and its income and other tax items are allocated among the members as set forth in the operating agreement (*e.g.*, based on their ownership percentages or unreturned capital contributions) and reported on the members' personal income tax returns.

Clients need to know that, generally, the LLC does not pay income taxes, but the LLC's members pay taxes on their allocated share of the LLC's income, whether or not they receive any cash distributions from the LLC (commonly known as phantom income). Clients also need to know that a person cannot be both a member and an employee of an LLC for tax purposes.[14] Instead, such a member is considered self-employed for tax purposes, resulting in the member paying all employment taxes (*e.g.*, Social Security and Medicare), including the employer's share of these taxes.

By contrast, a corporation pays taxes on its income, and the shareholders pay taxes on dividends received from the corporation, thus resulting in double taxation. If a corporation elects to be taxed as an S corporation, there is one level of taxation. An S corporation's income is allocated among the shareholders based on their ownership interests. The shareholders pay taxes on their allocated share of the corporation's income, which is reported on their personal income tax returns. Therefore, the tax treatment of an S corporation is similar to an LLC; however, with an S corporation income must be allocated based on the shareholders' respective ownership interests.[15] Unlike an LLC, there is no flexibility in making special allocations among shareholders of an S corporation.[16]

Limit the Scope of Services

If an attorney is not comfortable providing tax advice (or advice on any other issues, such as securities laws), he or she may limit the scope of services in his or her engagement letter.[17] In such a scenario, the attorney should work with his or her client's accountant or with a tax attorney or experienced corporate attorney. Otherwise, the client will expect his or her attorney to provide advice on all aspects and issues associated with doing business as an LLC.

Understand New Jersey LLC Law

Once it is determined that an LLC is the correct entity, an attorney must understand the law governing LLCs, including the differences between the new and old laws. The New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA)[18] became effective on March 18, 2013, for newly formed LLCs, and on March 1, 2014, for all LLCs, which is when the prior statute was repealed.[19] NJ-RULLCA made significant changes to New Jersey's LLC law. To name but a few differences, the new law provides for equal distributions to members regardless of their contributions or ownership interests in the LLC, includes specific fiduciary duties on managers or members of an LLC (discussed below), and does not provide for a buyout of a resigning or withdrawing member's ownership interest for fair value.[20] This is the law governing an LLC, unless the operating agreement alters these statutory defaults.

In this regard, an attorney needs to know which statutory provisions can be altered or eliminated and which statutory provisions cannot (because they are mandatory).[21] If an attorney does not understand NJ-RULLCA, he or she will not be able to draft an effective operating agreement.

Know the Issues to be Addressed in an Operating Agreement

An attorney forming an LLC needs to know what provisions should be included in an operating agreement and whether to alter or eliminate certain statutory default provisions.[22] For example, the parties may want to alter or eliminate the fiduciary duty of loyalty, which prohibits self-dealing and competition with the LLC.[23] If a member of an LLC lends money or leases real or personal property to the LLC, he or she is engaged in self-dealing. Although self-dealing sounds bad, it is common in small businesses. Therefore, self-dealing should be addressed in the operating agreement; for example, by outlining when and how a member may lend

money or lease property to the LLC.[24]

The members of the LLC may also want the ability to compete with the LLC. For example, the LLC may have been formed to hold a parcel of real estate. Under the fiduciary duty of loyalty, if a member wants to acquire another parcel of real estate, he or she must bring that opportunity to the LLC. If he or she doesn't, he or she is deemed to be competing with the LLC, which is a violation of the fiduciary duty of loyalty.[25] LLCs that are real estate holding companies usually eliminate this aspect of the fiduciary duty in their operating agreements.

The operating agreement should also address when and how distributions are made to members, including whether tax distributions must be made to members. If the operating agreement does not address distributions, then cash is distributed equally to all members, including dissociated members,[26] regardless of their ownership interests and capital contributions.[27] In an LLC, income may be allocated, but no cash distributed, to members for a variety of reasons, including the fact that the LLC needs the cash to fund operations. A tax distribution intends to provide cash to members so they can pay their taxes based on their allocated income.

The operating agreement should address the voting rights of members; otherwise, the statutory default provisions will apply. For example, the statute provides for equal voting of all members regardless of their capital contributions.[28] The member contributing the majority of the capital will not want equal voting. The statute also provides for unanimous approval of extraordinary actions, such as mergers.[29] The members of the LLC may not want unanimous approval; they may want majority or super-majority approval to prevent a minority member from having the power to veto extraordinary matters.

There are other provisions that should be included in an operating agreement aside from provisions altering or eliminating default provisions in the statute. For example, allocations of income and loss were addressed in the repealed statute,[30] but are not addressed in NJ-RULLCA. Therefore, they need to be addressed in the operating agreement. There are numerous other issues that should be addressed in an operating agreement, including the consequences of a member failing to make a promised capital contribution to the LLC and a member dying, becoming disabled, departing through resignation or termination, etc.[31]

Understand the Economics of the Deal

An attorney needs to understand the economic terms of the deal in order to properly draft an operating agreement. Without knowing the economics, an attorney will not know how to draft the allocation and distribution (including liquidating distribution) provisions of an operating agreement. For example, if one member is contributing cash and the other member is contributing services, is cash flow distributed 50-50 or is it first distributed to the financier until he or she receives the return of his or her capital contribution? In other words, does the financier receive a return of his or her money before the service member receives any cash distributions?

Upon liquidation of the LLC, are liquidating distributions to be made based on capital account balances, ownership percentages or some other method of distribution? There are real economic differences. An example would involve two members, each owning 50 percent of an LLC. The financier contributes $50,000 and the service member contributes $10,000 and a promise to provide services. Assume the LLC sustains a $20,000 loss in its first year of business and the members decide to liquidate the LLC at the end of the year. If liquidating distributions are based on capital accounts, the financier would receive $40,000 ($50,000 capital contribution less $10,000 loss) and the service member would receive nothing ($10,000 contribution less $10,000 loss). If liquidating distributions are based on ownership percentages, the financier and service member would each receive $20,000 ($60,000 total contributions less $20,000 loss, times 50 percent), which hardly seems fair to the financier. Without knowing the economics, and without explaining the different consequences to clients, an attorney may draft an operating agreement that has unintended results.

Use Checklists and Forms

An attorney should use a checklist when forming an LLC, especially when drafting an operating agreement. It is probably impossible to address every issue in an agreement, but using a checklist will minimize the possibility of forgetting to address an important issue. There are numerous checklists available, both in print and online, including a comprehensive checklist published by the American Bar Association.[32]

For the same reason, an attorney should also use form operating agreements to begin the drafting process. However, an attorney should not be a slave to the form. In other words, a form is a good starting place, but an attorney needs to revise and customize the form agreement to ensure it meets the needs of the specific LLC. There are several sources of good forms of operating agreements.[33]

Explain Operating Agreement to Clients

Once an attorney drafts an operating agreement, he or she should meet with the clients to summarize and explain its important provisions. Although an unpublished decision, attorneys should read *Cottone v. Fox Rothschild*,[34] which holds that an attorney must explain the provisions of an agreement to a client, even if he or she is a sophisticated business client. It modifies and extends the principles established by the New Jersey Supreme Court in *Conklin v. Hannoch Weisman*[35] about explaining the risks of transactions to clients in terms they can understand based on their needs and sophistication.

If a meeting or telephone conference cannot be arranged because of a client's schedule, reluctance to meet, or other reasons, an attorney should send a letter to the client summarizing and explaining the important provisions in the agreement and offering to answer any questions. It is a best practice to do so even after meeting with a client.

Confirm it in Writing

Finally, attorneys provide legal advice, but clients make decisions. An attorney may recommend a proposed course of action, but clients make decisions on whether to spend the money on such recommendations. In such an event, it is a best practice for an attorney to confirm his or her advice and the client's decisions in writing, which may minimize or even prevent future misunderstandings.

Conclusion

An attorney needs to be aware of and understand the issues outlined in this article and should discuss them with clients when forming an LLC. By doing so, an attorney will likely minimize or even avoid a claim of legal malpractice. ⚖

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ENDNOTES

1. A hat tip to John M. Cunningham, a member of the New Hampshire and Massachusetts bars and the principal author of *Drafting Limited Liability Company Operating Agreements* (Wolters Kluwer 2015), who has lectured and written on many of the issues addressed in this article.
2. These topics are addressed elsewhere. *See, e.g.,* New Jersey Model Civil Jury Charge 5.51A (available at judiciary.state.nj.us/civil/charges/5.51A.pdf); *Conklin v. Hannoch Weisman*, 145 N.J. 395, 416 (1996) (stating requisite elements of a cause of action for legal malpractice).
3. *See* New Jersey Rule of Professional Conduct 1.7 (Conflict of Interest—General Rule) and 1.5 (Fees). It should be noted that a violation of the Rules of Professional Conduct does not constitute malpractice, but it is evidence of malpractice. *See, e.g., Baxt v. Liloia*, 155 N.J. 190, 197-203 (1998).
4. New Jersey Division of Revenue, New Business Filing in 2014 (available from the author).
5. N.J.S.A. 14A:2-8.
6. N.J.S.A. 14A:5-2.
7. *See* N.J.S.A. 42:2C-30(b). A corporation's failure to observe such formalities is a factor in a claim for piercing the corporate veil to hold shareholders personally liable for the corporation's debts, liabilities and obligations.
8. *See* N.J.S.A. 14A:6-3(1) & 6-15(1).
9. N.J.S.A. 14A:6-1(1) & 6-15(4).
10. N.J.S.A. 42:2C-37(a).
11. N.J.S.A. 42:2C-11(i).
12. N.J.S.A. 14A:7-12(1).
13. N.J.S.A. 42:2C-41 & 2C-42. For other non-tax differences, *see John R. MacKay II, et al., New Jersey Corporations and other Business Entities* (3d ed.), Chapter 2, (Matthew Bender & Co., 2014).
14. *See, e.g.*, Rev. Rul. 69-184.
15. There are certain requirements or restrictions for a corporation to elect and maintain S corporation status. Among other things, there must be one class of stock only (although voting and non-voting stock are permissible), no more than 100 shareholders, and in general only individuals who are U.S. citizens and resident aliens may be shareholders. *See* 26 U.S.C. 1361(b).
16. For other tax differences, *see* Carter G. Bishop and Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law* (Warren Gorham & Lamont, 1994). For a basic discussion of the tax and non-tax differences between corporations and LLCs, *see* Gianfranco A. Pietrafesa, Choice of Entity: Corporation or Limited Liability Company? (March 2014), located at archerlaw.com/files/articles/Choice_of_Entity_-_Corporation_or_LLC_March_2014.PDF.
17. *See* RPC 1.2(c).
18. N.J.S.A. 42:2C-1 *et seq*.
19. N.J.S.A. 42:2C-91.

20. For a summary of the changes to New Jersey LLC law brought by NJ-RULLCA, *see* Gianfranco A. Pietrafesa, New LLC Law Became Effective on March 1st, 215 *N.J.L.J.* 619 (March 3, 2014), available at archerlaw.com/files/articles/ Pietrafesa_3.3.14.pdf; Gianfranco A. Pietrafesa, An Operating Agreement is Essential under RULLCA, 210 *N.J.L.J.* 664 (Nov. 19, 2012), available at archerlaw.com/files/articles/Pietrafesa_11_19_12.pdf.

21. *See* N.J.S.A. 42:2C-11.

22. For an article explaining the importance of a written operating agreement under NJ-RULLCA, *see* Gianfranco A. Pietrafesa, An Operating Agreement is Essential under RULLCA, 210 *N.J.L.J.* 664 (Nov. 19, 2012), available at archerlaw.com/files/articles/ Pietrafesa_11_19_12.pdf.

23. N.J.S.A. 42:2C-39(b).

24. Even if it is not addressed, NJ-RULLCA provides a safe harbor—self-dealing will not violate the duty of loyalty as long as the terms of the loan or lease are fair to the LLC. *See* N.J.S.A. 42:2C-39(g).

25. N.J.S.A. 42:2C-39(b)(3).

26. A dissociated member is one who has withdrawn from the LLC, either voluntarily or involuntarily. *See* N.J.S.A. 42:2C-46 (events causing dissociation). Among the limited rights of a dissociated member is the right to receive distributions from the LLC. *See* N.J.S.A. 42:2C-34(a).

27. N.J.S.A. 42:2C-34(a).

28. *See* N.J.S.A. 42:2C-37(b)(2) & (3).

29. N.J.S.A. 42:2C-37(b)(4) & (c)(4).

30. N.J.S.A. 42:2B-34 (repealed).

31. A checklist or comprehensive form of operating agreement, which are discussed below, may be used to identify issues to include in an operating agreement. For articles on other items that should be addressed in operating agreements, *see* Ira B Marcus and Denise Walsh, New Jersey Limited Liability Companies–Some Keys to Drafting Operating Agreements that Work, 240 *N.J. Lawyer Magazine* 18 (June 2006), and Peter Ehrenberg, Marie DeFalco and Brian Silikovitz, Learning to Live in the Brave New World of Limited Liability Companies: Avoiding the Ten Greatest Pitfalls in Structuring a Limited Liability Company, NJSBA *Business Law Section Newsletter* (circa 2004-2005), copies of which are available from the author.

32. The American Bar Association (ABA) checklist is available to ABA members at americanbar.org/tools/digitalassetabstract.html/content/dam/aba/publications/business_lawyer/2014/69_4/report-llc-checklist-201408.pdf, but prior drafts can be found online.

33. *See, e.g.*, Lawrence A. Goldman and Alyce C. Halchak, *New Jersey Limited Liability Company: Forms and Practice Manual* (2d ed.) (Data Trace 1995). *See also* 21A *New Jersey Practice Series, Skills and Methods* (3d ed.), § 46; 9 *New Jersey Forms: Legal and Business*, Ch. 18A; John M. Cunningham and Vernon R. Proctor, *Drafting Limited Liability Company Operating Agreements* (Wolters Kluwer 2015).

34. 2014 N.J. Super. Unpub. LEXIS 2143 (App. Div. Sept. 2, 2014).

35. 145 N.J. 395 (1996).